S. HRG. 113–171

HOUSING FINANCE REFORM: PROTECTING SMALL LENDER ACCESS TO THE SECONDARY MORTGAGE MARKET

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING COMPONENTS SUCH AS INFRASTRUCTURE, TECHNOLOGY, AND THE CASH WINDOW, THAT NEED TO BE PRESERVED FOR SMALL LENDERS IN A NEW HOUSING FINANCE SYSTEM

NOVEMBER 5, 2013

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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

C O N T E N T S

TUESDAY, NOVEMBER 5, 2013

WITNESSES

Additional Material Supplied for the Record

HOUSING FINANCE REFORM: PROTECTING SMALL LENDER ACCESS TO THE SECONDARY MORTGAGE MARKET

TUESDAY, NOVEMBER 5, 2013

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

Today we discuss a housing finance reform issue that is a top priority for many Members of this Committee, especially those from rural States: small lender access to the secondary mortgage market. While there is much to criticize about the current housing market, one of its strengths is that we have a national market for both single- and multi-family housing. Because of the existence of Freddie, Fannie, and other programs, the secondary market serves lenders of all sizes in all areas, keeping credit accessible and affordable for consumers across the country.

As we consider legislation to reform the housing finance system, I cannot overstate how important it is that we get the small lender access right. I applaud Senators Tester, Johanns, Heitkamp, and others for focusing on this issue and making progress on a solution. Senator Crapo and I also believe this is a crucial element of any legislation, and we continue the work to find the right path forward.

Today's witnesses will discuss their evolving thinking on how to protect small lender access to the secondary mortgage market and provide us with recommendations. They will also discuss what parts of the current system must be preserved and what parts can be improved in a new system.

Various proposals, including S.1217, suggest creating a mutual organization, or a cooperative, to act as an entry point for small lenders to the secondary market. We must think carefully about how such an entity would operate and be governed, as well as who should be its members, and construct it so that small lenders can continue to access the secondary market at a reasonable price and with ease. In addition, over 7,000 small financial institutions are members of the Federal Home Loan Bank System. Thus, we may also want to consider whether the Federal Home Loan Banks should play a larger role assisting their members to access the secondary market, and how.

Unlike many large lenders, most small lenders choose to service the loans they make, which enables small lenders to keep a connection to their consumers and their communities. As we heard at last week's hearing, this is often better for consumers, as many of the servicing problems we saw during the crisis came from lenders who sold their servicing rights. Thus, one of the essential tasks in building a new housing finance system will be to preserve the ability of small lenders to service their own loans.

If Congress passes housing finance reform without getting small lender access right, it will be the homebuyers in rural and underserved areas who pay the price for that mistake. For all those families, each of the organizations represented here today and we in Congress must work together to identify the best options that will work.

With that, I will turn to Ranking Member Crapo for his opening statement. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman. Today the Committee will hear about how we can protect small lenders' access to the secondary mortgage market. It is my understanding that key issues for small lenders in a reformed housing finance system are whether they will have adequate secondary market access and, if so, how that access will be structured and at what cost.

We have a broad panel of witnesses today, and I thank you all for coming to testify on this critical issue. This issue is important since small lenders represent the lifeblood of many communities across America, and especially rural communities in Idaho and elsewhere.

Lending used to be a community-based enterprise, relying on local knowledge and expertise to extend credit. In many community banks, credit unions and small lenders continue to operate that way even today despite increased regulatory burdens that often threaten this traditional model.

I mention regulatory burden on small lenders for a distinct reason. Small entities are already disadvantaged in the existing system. A recent Federal Reserve Bank of Dallas paper found that small banks are spending 10 to 15 percent of their net income on compliance costs. That same paper noted that a bank with less than $300 million in assets has to hire a full-time compliance officer because outsourcing compliance has become too expensive.

These troublesome regulatory cost estimates clearly indicate that a streamlining of regulatory requirements is needed to ensure that small lenders remain competitive. One of the ways to do this is to enable them to access the secondary market in an efficient manner. The secondary market allows lenders to make new loans by buying or pooling closed loans, thus enabling even small companies to originate relatively large volumes of loans.

Some small lenders prefer to sell loans and retain servicing rights in order to generate ongoing income and foster client relationships. Others prefer to sell loans to aggregators who treat them fairly. Yet not every small lender has the financial capacity or expertise to directly manage the complexities of the secondary market.

The legislation introduced by my colleagues, S.1217, goes a long way to address these issues and to provide affordable secondary market access for small lenders. It does so by providing two access points for small lenders: one through a cooperative, the so-called Mutual; and another by allowing Federal Home Loan Banks to securitize loans originated by their members.

The Federal Home Loan Banks know their customers well and are deeply involved in the local communities they serve. The Mutual would also be structured to serve the needs of its members: credit unions, community and midsized banks, and nondepository mortgage originators who know their customers through direct relationships. This approach has received positive reaction from small lenders.

One of the goals of the housing finance reform that we introduce should be to ensure that this new entity, the Mutual, can serve the needs of small lenders without exposing taxpayers to the unnecessary liability that we have seen in the past. This can be done only if the Mutual enables its members to access the secondary market without encouraging or requiring actions that would distort the market in any way.

We need to think about how to structure the Mutual so that its activities and the activities of its members result in a strong underwriting standard that will essentially protect the Mutual, its members, the communities they serve, and the taxpayers.

In order to accomplish that, we must reach consensus on how to structure the Mutual from an operational side, how to best fund it, what criteria for membership are appropriate so that the Mutual is adequately capitalized, and what safeguards are appropriate to ensure effective risk management.

Today's hearing is a good platform for that discussion, and I believe we can get on the same page regarding how to best address these issues. And again I thank you, Mr. Chairman, for holding this hearing.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who would like to give a brief opening statement? Senator Tester.

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Yes, thank you, Mr. Chairman, and it is brief because I am not going to be able to stick around for the questions. I just want to thank you and Ranking Member Crapo again for your commitment to have weekly hearings on housing finance reform and be able to mark up a bill before the end of the calendar year. I appreciate your leadership on this.

This issue is critically important to preserve access to the secondary market for community-based institutions, and it was a concern to me and Senator Johanns when we got on board with S.1217. We worked to craft a mutual securitization company framework and to enhance the role of Federal Home Loan Banks.

The goal with these mechanisms, which enable community-based institutions to access the secondary market, is to leverage economies of scale, to put smaller institutions on equal footing with their large competitors. That way we can get the pricing that—they can get the pricing and the execution that they deserve based on high credit quality of the loans that they underwrite.

Obviously Senator Johanns and I are committed to ensuring that these provisions work, and I want to thank all the stakeholders here today for their input and suggestions which were integral in helping us draft this legislation and for all their continued input on ways to further improve the bill as we move forward.

The bottom line is that there is broad consensus from both the sponsors of this legislation and the stakeholders about ways that this legislation can be improved and, more importantly, there is a shared commitment to ensure that housing finance reform works for community-based institutions.

I know that many of the stakeholders here today have been working together to drill down on these issues, and I am confident that if we get the right folks together in the same room, we can resolve any issues easily and quickly.

I look forward to working with the Chairman and Ranking Member to tweak this legislation to ensure that it works for community-based institutions, and I stand by ready to assist in any way that I can so we can get this bill to the President's desk sooner rather than later. Why? Because I believe we have a limited window of opportunity here, and I am afraid that it will get much more difficult if we fail to seize on that window of opportunity.

Thank you, Mr. Chairman.

Chairman JOHNSON. Anybody else?

[No response.]

Chairman JOHNSON. I would like to remind my colleagues that the record will be open for the next 7 days for additional statements and other materials.

Our first witness is Mr. Richard Swanson, president and CEO of the Federal Home Loan Bank of Des Moines, testifying on behalf of the Council of Federal Home Loan Banks;

Mr. William A. Loving, Jr., president and CEO of Pendleton Community Bank and chairman of the Independent Community Bankers of America;

Mr. Bill Hampel, senior vice president and chief economist at the Credit Union National Association;

Mr. Bill Cosgrove, president and CEO of Union Home Mortgage Company and chairman-elect of the Mortgage Bankers Association;

Mr. John Harwell, associate vice president of risk management at Apple Federal Credit Union, testifying on behalf of the National Association of Federal Credit Unions;

Finally, we have Mr. Jeff Plagge, president and CEO of Northwest Financial Corporation and chairman of the American Bankers Association.

We welcome all of you here today and thank you for your time.

Mr. Swanson, you may begin your testimony.

STATEMENT OF RICHARD SWANSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL HOME LOAN BANK OF DES MOINES, ON BEHALF OF THE COUNCIL OF FEDERAL HOME LOAN BANKS

Mr. SWANSON. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, I am Richard Swanson, president and CEO of the Federal Home Loan Bank of Des Moines, a federally chartered cooperative owned by nearly all of the 1,200 financial institutions in the States of Minnesota, Iowa, Missouri, North Dakota, and South Dakota. I appreciate the opportunity to speak to you today on behalf of the Council of Federal Home Loan Banks.

More than 7,500 financial institutions of all sizes, including commercial banks, savings banks, credit unions, insurance companies, and CDFIs, are members of the Federal Home Loan Banks. Most of them are active mortgage lenders who use advances from their Federal Home Loan Bank to help fund loans that could be held in their own portfolios, such as adjustable rate mortgages.

With almost $500 billion of outstanding advances today, providing collateralized funding to our members is our primary business line and one that needs to be preserved.

Most lenders have difficulty managing the interest rate risk associated with holding long-term fixed-rate loans on their balance sheets. As a result, they typically sell those loans into the secondary market where they are pooled into large mortgage-backed securities. When selling their loans into the secondary market, the smaller lenders face particular challenges. This morning, I will focus on two of these challenges and the role the Home Loan Banks play in helping small lenders deal with them.

The first challenge for smaller lenders is one of volume. How can a few loans from many lenders be efficiently gathered and sold into the secondary market at pricing for the combined volume that is competitive with the large lenders? Building upon our longstanding business relationships with members, the Home Loan Banks developed mortgage programs to help smaller lenders meet this volume challenge.

We purchase mortgages in small volumes from over 1,600 of our members at pricing comparable to what the large lenders were getting from Fannie and Freddie. Initially we held all of these loans as long-term investments. Now we are also leveraging the scale of these mortgage programs to facilitate the sale of mortgages by smaller lenders directly to secondary market buyers, but at prices reflecting their collective volume.

In the reformed secondary market contemplated by S.1217, Fannie and Freddie will no longer dominate the aggregation, pooling, and securitization functions. These functions will be distributed among more parties, potentially including the Home Loan Banks. By aggregating and pooling loans in sufficient volumes for issuance in mortgage-backed securities, we could further improve secondary market pricing for our smaller members.

The second challenge for smaller lenders facing the secondary market relates to value. Smaller lenders tend to originate mortgages that perform better and are, therefore, more valuable to investors. How do smaller lenders get paid for this added quality? Our mortgage programs allow smaller lenders to retain a portion of the credit risk of each mortgage they sell to us. If their loans perform well, the members receive a credit enhancement fee to reward them for the value of their loans.

Over the past 15 years, the Home Loan Banks have purchased more than $200 billion of mortgage loans with this risk retention feature. With our members' skin in the game, these loans have experienced total losses of less than 15 basis points, or less than one-seventh of 1 percent of the original principal amounts. This is an extraordinary result.

In the secondary market contemplated by S.1217, any pool of mortgages securitized with the backstop Government guarantee would require private capital insurance covering the first 10 percent of losses. If this private capital loss coverage is provided in a competitive market by multiple parties, we could seek bids for that coverage on pools of higher-value mortgages originated by our members, which should command a lower premium. Members might also elect to retain part of the risk on mortgages they sell as they do under our portfolio mortgage programs. We have the experience to manage such a skin-in-the-game program which may enable us to negotiate an even better price for their private capital guarantee or a credit enhancement fee to members if their mortgages perform well.

We are pleased that S.1217 recognizes the importance of lenders of all sizes in a reformed housing finance system and contains specific provisions to assure competitive and reliable secondary market access for smaller lenders. We also appreciate that the bill provides different alternatives for the Home Loan Banks to serve their members as the housing finance system evolves. We stand ready to perform that mission.

Thank you.

Chairman JOHNSON. Thank you.

Mr. Loving, please proceed.

STATEMENT OF WILLIAM A. LOVING, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, PENDLETON COMMUNITY BANK, FRANKLIN, WEST VIRGINIA, AND CHAIRMAN, INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. LOVING. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, my name is William A. Loving, Jr., and I am president and CEO of Pendleton Community Bank, a $260 million asset bank in Franklin, West Virginia. I am appearing today as chairman of the Independent Community Bankers of America, and thank you for convening this hearing. ICBA sincerely appreciates the opportunity to work with the Committee to craft housing finance reform legislation.

Community banks represent approximately 20 percent of the mortgage market, and secondary market sales are a significant line of business for us. Though Pendleton Community Bank holds most of its mortgage loans in portfolio, in recent years we have sold an increasing volume of loans into the secondary market. We would sell more, but many rural properties are disqualified because of the current underwriting and appraisal guidelines of the GSEs.

Pendleton's secondary market sales are driven by customer demand for 30-year fixed-rate loans. For a community bank, it is prohibitively expensive to hedge the interest rate risk that comes with fixed-rate lending. Secondary market sales eliminate this risk. As the housing market recovers, with more flexibility, I expect we will continue to sell an increasing number of loans. Secondary market access is critical even for a portfolio lender such as Pendleton.

The current GSE secondary mortgage market structure has worked well for community banks. It permits them to effectively hedge interest rate risk and offer rate locks with relative ease and at a low cost. They access this market on a single-loan basis, enjoy a virtually paperless loan delivery process, and generally receive funding from the GSEs in cash within 24 to 48 hours. Any new system of housing finance must be able to match the clear advantages of direct GSE sales enjoyed by community banks today.

ICBA is grateful to Senators Warner, Corker, and all the Committee cosponsors for introducing S.1217. ICBA sincerely appreciates the opportunity to provide input into this bill. We are encouraged by the inclusion of certain provisions to address ICBA's concerns, including the Mutual Securitization Corporation which would secure access to the secondary market for community banks and allow them to sell loans on a single-loan basis, be paid in cash, and retain the servicing rights.

However, the success of the Mutual depends on the details and the implementation. My written statement contains more detail. For now, I will focus on two recommendations we have for improving the Mutual.

The first concern is its capitalization. The Mutual must be well capitalized to provide competitive pricing of credit enhancements and guarantees. However, because community banks cannot provide the majority of the initial capitalization, ICBA recommends using the profits of the current GSEs—or at least a portion of them—to capitalize the Mutual, which could be repaid over time through the Mutual's operational earnings.

Our second recommendation concerns eligible sellers to the Mutual, a question that is critical to its viability, competitiveness, and ability to provide liquidity for all market participants. ICBA recommends all current approved GSE sellers and servicers with assets up to $500 billion be eligible to sell and service mortgages. While the Mutual is targeted toward small and midsized lenders, some larger institutions may prefer to sell loans for cash rather than securitize them. Allowing more lenders to access the Mutual will help build the scale needed to secure competitive terms for third-party credit enhancements and improve liquidity for all sellers. The 15-percent cap on securities guaranteed by the FMIC will help limit concentration.

ICBA has additional recommendations for improving S.1217. A particular concern is excessive complexity. A system that is too complex and entails too much risk would force additional market consolidation and shift yet more control to the largest lenders and Wall Street firms. Equal and direct access to the secondary market is a vital component for community banks. The Mutual must have a specific duty to serve all markets, including small towns and rural communities. Efforts to restructure the housing finance system must protect this critical portal for small financial institutions.

Thank you again for the opportunity to testify today. I look forward to answering your questions.

Chairman JOHNSON. Thank you.

Mr. Hampel, you may proceed.

STATEMENT OF BILL HAMPEL, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, CREDIT UNION NATIONAL ASSOCIATION

Mr. HAMPEL. Thank you. Chairman Johnson, Ranking Member Crapo, Members of the Committee, I am Bill Hampel, chief economist for the Credit Union National Association, the largest credit union advocacy organization in the U.S. We represent America's State and federally chartered credit unions and their 97 million members.

Credit unions are now significant players in residential mortgage lending, and my comments today reflect the views of our credit unions and the needs of their members.

Qualifying credit union members need to be able to borrow to finance their homes in a stable market with predictable costs. For credit unions, so long as they produce one or more eligible mortgages, they should be able to sell them to an issuer of Government-backed securities, directly or through an aggregator, at market prices, for cash, without low-volume penalties, and with the option to retain servicing. We do not have too long a list there. In addition, standardization of all steps in the process is very important to credit unions.

CUNA believes that the general approach of S.1217 is well thought out and sound public policy. However, we do have several suggested improvements to the bill that will be necessary for it to work for small lenders.

Regarding the operations of the Mutual Securitization company, I have three suggestions.

First, it should be available to all lenders regardless of size that do not themselves or through a subsidiary issue covered securities. Restricting the Mutual to lenders with less than $15 billion in assets would not allow for necessary scale economies and could adversely affect the liquidity of securities issued by the Mutual. In fact, it would be desirable for the Mutual to be among the largest if not the largest issuer of covered securities.

Second, the Mutual's governance should be as a cooperative, with a board elected to represent all classes of membership, elected by and from each group, by type and size of lender. The basic mission of the Mutual, to provide unfettered access to the secondary market for lenders of all sizes, should not be subject to change.

Third, the Mutual should be allowed a small but limited balance sheet—enough to pool mortgages before a sale into securities and perhaps to hold some modified mortgages.

Regarding the private provision of the first 10 percent of loss on covered securities, we have five suggestions.

First-loss coverage should only be available through bond guarantors as opposed to securities structures. Bond guarantors would be much more stable as sources of private capital than senior subordinated deal structures across all phases of the business cycle. In addition, securities structures are likely to favor larger lenders.

Second, when financial markets are stressed, rather than temporarily waiving the requirement for first-loss coverage, the FMIC could sell such coverage to issuers at a price determined by formula. Once markets calm down, FMIC could sell that first-loss coverage to private bond guarantors. This would allow the Government to mimic market functions when they are not operating properly while providing for a quick return to private participants once markets stabilize.

Third, the liability of the bond guarantor should be limited to the first 10 percent of loss on each security or perhaps a limited vintage of securities and not to the entire book of business of the guarantor. Therefore, the payment of some losses by FMIC out of its reserves need not be considered a catastrophic event, especially considering that those reserves will have been provided by private market participants.

Fourth, the amount of capital reserves required of bond guarantors should be sufficient to cover the first 10 percent of loss on covered securities under conditions as severe as the recent Great Recession. Since not all securities would suffer 10-percent losses in this scenario, this would require substantially less than 10 percent of the total exposure of each bond guarantor, and the adequacy of reserves should be determined by FMIC.

And, finally, to avoid "too big to fail" problems with large securities issuers, bond guarantors should be distinct from any issuer of covered securities.

Regarding underwriting standards, the coexistence of underwriting standards from both the Qualified Mortgage rule and future secondary market requirements will be confusing and problematic to credit unions and other lenders. This issue has been temporarily dealt with by granting QM status to any loan that qualifies for purchase by the enterprises. Before that exemption expires, steps should be taken to combine underwriting requirements to meet the needs of both, of consumer protection and efficient operation of the secondary market.

I have a couple of suggestions on additional provisions specific to credit unions to add to S.1217.

First, we believe that credit unions may need additional investment authority in order to capitalize their share of the Mutual.

And, second, we encourage the Committee to include language that would amend the Federal Credit Union Act to consider all loans made on one- to four-family residential properties as residential loans, as is currently the case for commercial banks.

And, finally, one point not related to S.1217, largely due to concerns with vendor readiness, a 1-year extension of January's compliance deadlines for CFPB's new mortgage rules would be optimal. Failing that, we urge Congress to encourage more time before examiners begin to write up financial institutions. Equally important, Congress should provide a reasonable delay in the private rights to sue.

Thank you, and I look forward to your questions.

Chairman JOHNSON. Thank you.

Mr. Cosgrove, you may proceed.

STATEMENT OF BILL COSGROVE, CHIEF EXECUTIVE OFFICER, UNION HOME MORTGAGE CORP., AND CHAIRMAN-ELECT, MORTGAGE BANKERS ASSOCIATION

Mr. COSGROVE. Thank you. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, my name is Bill Cosgrove and I am a certified mortgage banker. I have 28 years of experience as a mortgage banking professional. I currently serve as chief executive officer of Union Home Mortgage Corp., headquartered outside of Cleveland. I am also chairman-elect of the Mortgage Bankers Association. My company was founded in 1970, and I purchased it in 1999. Our family owned business employs 278 individuals, and we are very proud that since 1999 we have helped more than 50,000 homebuyers finance and refinance homes and achieve their dreams of home ownership.

Small and midsized lenders play a crucial role in today's housing finance system. Seventy-four hundred lenders originated mortgages in 2012. Fannie Mae and Freddie Mac each report that roughly 1,000 lenders are direct sellers to the GSEs, and Ginnie Mae currently has more than 250 issuers. The vast majority of these lenders are smaller independent mortgage bankers and community banks. In fact, according to the most recent HMDA data, independent mortgage bankers represent 11 percent of all lenders nationwide, yet they originate 40 percent of all purchase money mortgages in 2012. Over the course of the next year, small lenders will become increasingly important as we transition from a predominant refinance market to a purchase market.

It is important to recognize that not all small lenders have the same needs when it comes to accessing the capital markets for mortgages. Lenders with the skills and the capital should be in a position to make their own choices about how, when, where, and to whom to sell their production, based on their core competencies and other strategic objectives.

As policy makers consider both transitional and end-state reforms, the future secondary market needs to provide direct access, on competitive terms, for those lenders who can take care of the requisite responsibilities. In particular, small lenders need a secondary market system that delivers: (A) price certainty that represents the risk of the underlying loan; (B) execution for both servicing-retained and servicing-released loans; (C) single-loan and/or small pool executions with a low minimum pool size; (D) ease of delivery; and (E) quick funding.

Single-family lenders should be able to utilize familiar credit enhancement options, such as mortgage insurance, to facilitate secondary market transactions in a timely and orderly way. Key functions present in today's secondary market system should be preserved, while allowing new forms of private credit enhancement to develop over time.

Congress should give serious consideration to expanding Federal Home Loan Bank membership eligibility to include access for nondepository mortgage lenders. These lenders are often smaller, community-based mortgage bankers or servicers focused on providing mainstream mortgage products to consumers.

S.1217 proposes a system that is closer in many aspects to the Ginnie Mae model. Lenders are issuers and are responsible for obtaining private credit enhancements before delivering pools of loans to the central securitization platform for the Government guarantee. This approach may work for some lenders, but may be too operationally difficult for many small lenders. S.1217 provides an alternative for smaller lenders in the form of a mutual securitization company, a cooperative that takes the role of the aggregator and issuer. S.1217 also provides for the Federal Home Loan Bank System to be aggregators for smaller lenders. Regardless, broad standards for a mutual should ensure a fair governance process that does not advantage one class of mutual shareholders over another.

It is equally important to ensure that the end-state reforms address a variety of ways that small lenders access the secondary market and that any mutual company created is not the only option for small lenders.

Additionally, as Congress considers broader reforms to the secondary market, care must be taken to ensure a smooth transition and that switching costs to a new system does not create major barriers to participation by smaller lenders.

Key GSE assets, including technology, systems, data, and people, should be preserved and redeployed as part of any transition associated with GSE reform. For example, certain assets could be moved into the common securitization platform.

Other assets, such as automated underwriting systems, could be made broadly available through a public leasing program or auctioned with conditions that ensure access to all market participants.

Making the secondary market work for smaller lenders is critical for providing a competitive market, which ultimately benefits homebuyers. We urge you to ensure that secondary market reform provides smaller lenders with opportunities for direct access.

Thank you again for this chance to continue the critical dialog with the Members of this Committee.

Chairman JOHNSON. Thank you.

Mr. Harwell, please proceed.

STATEMENT OF JOHN HARWELL, ASSOCIATE VICE PRESIDENT OF RISK MANAGEMENT, APPLE FEDERAL CREDIT UNION, FAIRFAX, VIRGINIA, ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. HARWELL. Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. My name is John Harwell, and I am testifying today on behalf of NAFCU. I appreciate the opportunity to share NAFCU's views on housing finance reform.

Key issues in the housing finance reform debate for credit unions include: maintaining unfettered guaranteed access to the secondary mortgage market; an explicit Government guarantee on mortgage-backed securities; fair pricing and fee structures that reward loan quality; ensuring market feasibility of a mutual should such an entity be adopted; flexible underwriting standards that will allow credit unions to best serve their members; and adequate transition time to a new housing finance model.

While credit unions hedge against interest rate risk in a number of ways, selling products for securitization on the secondary market remains a key component of safety and soundness.

About a third of Apple Federal Credit Union loans are sold on the secondary market to Freddie Mac. Apple has maintained the servicing on those loans, as it is important to us to keep that interaction with our members in any reform. NAFCU and its member credit unions cannot support any approach that does not maintain an explicit Government guarantee of payment of principal and interest on MBS. The approach found in S.1217 where private capital stands in front of the guarantee offers a viable public–private solution.

Fannie Mae and Freddie Mac play important roles for credit unions. Key elements of the current system, such as the ease of transaction and the standardization credit unions currently experience when using software provided by Fannie and Freddie, must be maintained. Furthermore, even though Apple is currently not using it, the function of the cash window at the GSEs is also vital to credit unions.

In the context of S.1217, NAFCU believes the establishment of the FMIC Mutual Securitization company is a workable solution to help guarantee secondary market access for credit unions. While NAFCU believes that the proposed Mutual is a viable option, we appreciate the sponsors' openness to improving it.

NAFCU has concerns about the $15 billion cap for participation in the Mutual and believes any cap should be substantially higher. Standards for participation in the Mutual should be set by its board of directors, which should be elected by the membership and include at least one Federal credit union representative. Since the Mutual would be the guaranteed route to access the secondary market for small lenders, especially in difficult times, it is important that there be a streamlined process to become a member.

NAFCU believes that the fee structures associated with the Mutual, whether it is to capitalize or to sustain it over time, should be based on loan quality as opposed to the volume of loans an entity generates. Congress should consider the Mutual having some type of Government seed money that will help the Mutual get off the ground and encourage qualifying entities to participate from day one. Such funds could be paid back over a period of years from the profits of the Mutual.

NAFCU could support the Federal Home Loan Banks being one option for credit union access to the secondary mortgage market as proposed in S.1217. However, this cannot be the only mechanism in place for credit unions to gain access. Having multiple options will allow credit unions to choose the avenue that works best for them and help ensure healthy competition for their loans, which can help with fair pricing.

Should Congress act to reform the Nation's housing finance system, getting the transition right will be critical. My written testimony contains additional thoughts on this process.

Finally, NAFCU maintains concerns about the Qualified Mortgage standard included in S.1217 for loans to be eligible for the Government guarantee. Underwriting standards may be best left to the new regulator and should not be established in statute. Doing so would allow the regulator to address varying market conditions and act in a countercyclical manner if needed.

Credit unions make good loans that work for their members that do not all fit into the parameters of the QM box. Using the CFPB QM standard for the guarantee would discourage the making of non-QM loans. My written testimony outlines additional concerns with the QM standard.

In conclusion, NAFCU appreciates the Banking Committee's bipartisan approach to housing finance reform. In any reform, it is vital that credit unions continue to have guaranteed access to the secondary market and get fair pricing based on the quality of their loans and that the Government continues to provide a guarantee to help stabilize the market.

Thank you for the opportunity to provide our input on this important issue. I would welcome any questions that you may have.

Chairman JOHNSON. Thank you.

Mr. Plagge, you may proceed.

STATEMENT OF JEFF PLAGGE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NORTHWEST FINANCIAL CORPORATION, ARNOLDS PARK, IOWA, AND CHAIRMAN, AMERICAN BANKERS ASSOCIATION

Mr. PLAGGE. Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. My name is Jeff Plagge. I am president and CEO of Northwest Financial Corporation of Arnolds Park, Iowa, and chairman of the American Bankers Association. Northwest Financial Corp. is a privately owned banking organization. We have two banks with approximately $1.6 billion in assets. We make between 3,000 and 3,500 mortgage loans a year in our markets, and with the exception of Des Moines, Iowa, and Omaha, Nebraska, they are all rural markets.

The majority of these loans are sold into the secondary market, but we also portfolio loans, especially in some of our more rural markets due to loan size or some of the other issues that make it difficult to work in the secondary market. Mortgages are a big part of our business model, and any changes affecting mortgage lending are very important to us, our customers, and our communities.

We commend the Committee for its focus on these issues, and particularly Senators Corker and Warner and the cosponsors of S.1217, in establishing a framework to build on. ABA agrees with the sponsors of S.1217 that a secondary market Government guarantee is important and particularly to low- and moderate-income housing borrowers. That guarantee must be explicit, fully priced into the cost of each mortgage, and, most importantly, available to all eligible primary market lenders, regardless of their size, charter type, geographic location, or number of loans sold into the secondary market. Community banks must remain able to access that guarantee. If community banks' access is curtailed or denied or their pricing in the market is inequitable, they and the communities they serve will suffer.

As important as this Federal Government support is, going forward it should be within a mortgage market predominantly filled by the private sector. Fostering a private market for the majority of housing finance must be part of any Federal policy and should be balanced with Government support for certain segments of that market.

We believe that a mutual organization—if structured in an economically viable way and with appropriate governance—may be a promising approach to the secondary market liquidity. It must be structured to ensure equitable access for all members, regardless of size or charter. This would require a governance structure that balances the rights and needs of all members.

The Federal Home Loan Bank System can serve as a model for such governance as it is cooperatively owned but its governance rules provide the necessary balance for all members.

Whatever structure is adopted, it must include the ability to sell loans individually or in small numbers for cash. This cash window is essential for small lenders. My bank sells loans via the cash window, and it is hard to have sufficient volume to execute our own mortgage-backed securities, and the interest rate risk and pipeline management would be too difficult.

Sellers must also be able to retain servicing or sell it. Our larger bank does retain servicing rights on many loans, and we now service approximately $587 million of Freddie Mac loans. Our customers always prefer that we service their mortgages, but capital limitations affect how much we can hold in mortgage servicing rights.

We believe that any reform of the secondary market must recognize the vital role played by the Federal Home Loan Banks. We do believe that an enhanced role for the Federal Home Loan Banks holds promise. Just like the Mutual structure, finding the necessary capital to support additional activities will be the challenge, and there will be new risks that would require appropriate oversight.

A more limited expansion of the Federal Home Loan Banks may be feasible, such as expanding aggregation of mortgages for security issuers and potentially the issuing of securities by Federal home loans banks. Whatever changes are made, Congress must not harm access to traditional advances for all banks and particularly community banks.

Reforming the mortgage markets will be a complex undertaking with far-reaching consequences for our economy. It must be undertaken in a thoughtful, orderly manner and done with careful transition over a number of years to ensure that the mortgage markets are not destabilized.

As you consider these changes from the perspective of community banks, the key requirements are equal access, equal pricing, multiple channels, and reasonable capital requirements. We are committed to work with the Committee to achieve a sustainable, durable, and equitable system.

Thank you very much.

Chairman JOHNSON. Thank you. Thank you all for your testimony.

As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member.

Each of you highlighted the importance of preserving the cash window underwriting systems and servicing rights as well as creating a well-structured mutual organization. Understanding your are all still working on recommendations on these complicated issues that you will send us, how important is it to your organizations' members and their customers that we get it right? Mr. Hampel, let us start with you, briefly.

Mr. HAMPEL. Thank you, Chairman Johnson. It is absolutely essential. Credit unions do not always sell all their loans. They often will hold onto a significant portion of them. However, as others have testified, there are times when we have to sell loans, and for our members to have access to loans that are funded by the secondary market the way all other loans are, it is absolutely crucial that this be done right.

The previous system did not work. It broke on us and created big problems. However, there are pieces of that previous system that we need to maintain and bring into the new system, fixing the design flaws.

Chairman JOHNSON. Mr. Cosgrove, do you agree with Mr. Hampel?

Mr. COSGROVE. Absolutely, Chairman. There is no doubt that the old system at times with G-fees based on volume versus the actual risk of the credit picked winners and losers, and a lot of times the small lender would be the loser in that scenario. So it is absolutely critical, yes.

Chairman JOHNSON. Mr. Loving, do you agree?

Mr. LOVING. Yes, I do. I think it is essential that we get this right and that we protect the ability to sell loans on a single basis, retain the ability to service rural areas in America, and particularly some of the underwriting guidelines and appraisal standards today prohibit the sale of loans from rural America. So I think it is critical that this is processed deliberately and that the end result is correct.

Chairman JOHNSON. Mr. Plagge, do you agree?

Mr. PLAGGE. I do as well. You know, when you think about all the intersecting risks that are going on right now with mortgage reform and Basel III capital requirements, QE, maybe the unwinding of QE, there are a lot of things going on, and we need to really work hard. And I commend the Committee for all the work they have done already. It is quite interesting, the unanimity between the discussions here with the Committee Members. And so I think we have a ways to go. We have a lot of decisions to make, and I think the transition timing is going to be the critical part of it, that we do not go too far without making sure the system is working.

Chairman JOHNSON. Mr. Harwell, do you agree?

Mr. HARWELL. Yes, sir, I do. We would also like to ask that there would be some kind of overlap in the structure if and when the new system comes online so that there is no disruptive forces in the market.

Chairman JOHNSON. Mr. Swanson, S.1217 creates a Mutual and authorizes the Home Loan Banks to apply to be an issuer. Before the old system is shut down, what targets would need to be hit during a transition to verify that the Mutual and the home loan bank issuer can coexist while providing equal access to the smallest lenders?

Mr. SWANSON. Thank you, Chairman Johnson. The outlines in S.1217 of a Mutual provide an interesting start, but it is hard for us to answer in detail the question of how a transition would work.

As far as the Federal Home Loan Banks are concerned, we are suggesting that we can build on the experience that we have had in our existing programs to expand our role in providing access to members. The programs that we have, have grown organically over the last 15 years. We have learned lessons along the way, and they have evolved in response to the needs that our members have expressed through the voice of their directors of our cooperatives.

We think it is important for smaller lenders to have alternatives. We do not see the Federal Home Loan Banks as being the sole point of access by any means.

So as we look to the future, it is important for us to respond to the voices of our members, and I think it is significant, without rehashing the testimony that the six of us have given this morning, that five others who represent our members are very much in agreement with what they want from the Federal Home Loan Bank, and it would be our obligation to serve that interest.

Chairman JOHNSON. Mr. Loving, is the system in S.1217 more complex than the current system? And what are the impacts of a highly complex system on small lenders?

Mr. LOVING. Thank you. I would not say that the elements of S.1217 are more complex or less complex than the current system, but I will tell you that any system that is complex creates problems for smaller community-based financial institutions, community banks. In dealing with the underwriting requirements, the appraisal guidelines that are in place today, it does—it prohibits access to the market. So I think any future model needs to be simple. It needs to be designed so that any community bank of any size can process mortgages, can present their loans for cash, and participate in the process.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

My first question really is more of a request. Each of our witnesses today represents small lenders in some capacity, even though your membership is very diverse. And given the fact that we are working very hard to try to get a markup ready for action here in the Committee in the near-term future and each of you has somewhat different perspectives on how we should establish it and put it together, I am just going to ask you if you will all agree to work with us and, in fact, to work together to come up with a sensible, mutually agreeable solution for how to best structure the small lenders' access to the secondary market using the basis that we are working from here and essentially help this Committee get to a work product as fast as you can. Does anybody have any problem with agreeing to work together to get that done for us? I did not think so. But I do make that request because we really do need your assistance as we approach these importance structural decisions that we are making.

My next question is to Mr. Loving and Mr. Plagge. Your organizations represent banks, including small and community banks, and with respect to how the Mutual should be structured, it would be beneficial to know what would entice your members to fully participate and take advantage of this new co-op that is proposed in Senate bill 1217. Could you just quickly each give me an answer on that?

Mr. LOVING. Certainly. I think the structure is important, and representation is equally as important. As the Mutual is designed, I think, representation of community banks, such as the Community Bank Council that is in existence in other agencies, as well as governance of the Mutual is important so that there is a voice of community banks in the formation and the operation of the Mutual itself. Of course, obviously price and ease of access is just as important.

Senator CRAPO. Thank you.

Mr. Plagge.

Mr. PLAGGE. Along with those things, you know, we are probably more of a proponent of more of a wide open Mutual membership from all sizes, and it really goes down to the capital equation to make sure that we do not limit ourselves or limit the scale and opportunities of that Mutual. And so rather than just create a Mutual for small banks only, open it up further and let others become part of that, and that way we think we assure the capital structure better in the long run.

Senator CRAPO. Just quickly to both of you, and I mean very quickly, should the Mutual's membership criteria be capped at a certain threshold? And if so, what kind of threshold should we look at? Mr. Loving.

Mr. LOVING. I am not sure it should be capped at a threshold. I think the more participants in the Mutual provides capitalization in the scale that is needed for the efficiency of both operation and price.

Senator CRAPO. Thank you.

Mr. Plagge.

Mr. PLAGGE. I would agree with that, and to me that becomes the Government's model, make sure that all voices are heard and everybody has a voice. Again, the Federal Home Loan Bank has a pretty solid governance model that could be copied.

Senator CRAPO. All right. Thank you.

Mr. Hampel and Mr. Harwell, I want to go to you next, the credit unions, and basically ask the same question. What do we need to assure that we generate the interest and support of the credit unions in moving into this new model?

Mr. HARWELL. Credit unions will have to be able to afford to get into it to generate enough loans to make the Mutual work, you know, with our other colleagues. So we think that is the biggest issue for us.

Senator CRAPO. Thank you.

Mr. Hampel.

Mr. HAMPEL. Senator, I believe what credit unions would hope for is that the Mutual be substantial enough to serve their needs and that it would be stable enough for them to be able to count on it for the long run with a standardized set of processes that they can always go to regardless of the amount of volume that they are bringing.

Senator CRAPO. Thank you. And, again, to both of you, the same question that I asked before about the cap. The question is: Should membership criteria be capped at any threshold?

Mr. HAMPEL. We do not believe it should be capped. We do think that it would be useful to define membership by function and that any entity that is also issuing covered securities would not also be able to use the Mutual. And it is because of that, because the Mutual could get large as a result of this, that it should be restricted to being a securitization utility and not also provide the guarantee.

Mr. HARWELL. We agree

Senator CRAPO. You agree? All right. Thank you.

Now, Mr. Swanson, with regard to the Federal Home Loan Banks, you have a good experience and a very low level of credit losses because of the high-quality loans that you originate. What specific requirements are in place to ensure in your system that mortgages underwritten by your members are sound? And what lessons should we draw from that as we put together this legislation?

Mr. SWANSON. Our mortgage programs have focused on the conforming mortgage part of the market, so underwriting guidelines have generally followed the Fannie and Freddie guidelines.

What we have done in our portfolio programs where we purchased mortgages from our members is we have had this skin-in-the-game feature that I mentioned earlier. There are a couple of different versions of it, but essentially it involves the member retaining some portion of credit risk between 1.5 or 2 percent and 4 percent, depending on the original loan, and then receiving a credit enhancement fee back if the mortgage performs properly.

To the extent that loans need to find a place in the secondary market that do not meet rigid requirements and are not easily guaranteed, that kind of structure may provide a model where you could have a skin-in-the-game option for secondary market loans from small lenders that do not fit a very narrow underwriting box.

Senator CRAPO. Thank you.

And, Mr. Cosgrove, I am not leaving you out. I have run out of time, so I will submit a question to you, if you do not mind, later.

Mr. COSGROVE. Sure.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and thank you and Ranking Member Crapo for all the good work you are doing.

I wanted to actually press a little bit even harder than my friend Senator Crapo. For those of us who have been working over a year on S.1217, we appreciate some of your general comments, but also recognize there are lots of ways to improve this bill. I guess what I would urge is that, working with Committee staff, you will agree, within a very, very short period of time, whatever Committee staff thinks is appropriate, that you actually get your specific comments, if we are going to move this legislation, in a timely manner. Without those specific comments, language comments, we are not going to get there.

I guess I would ask, does anyone feel that if we do not move quickly that this window of GSE reform may close on us? Does anyone feel that the current system is sustainable?

Mr. HAMPEL. Go for it.

Senator WARNER. Great. So I would take that as—I hope that will be days or weeks in terms of getting your comments in specific language, because, you know, we have been back and forth on lots and lots of these iterations for some time now, and without language, without specific language, we are not going to get there.

Mr. Hampel, one of the things that—and I also want to acknowledge Mr. Harwell as well from Virginia. I am glad we have all got our "We voted today" signs on. Mr. Hampel, one of the things that we have thought a lot about is trying to get this transition right. And you have not—you know, we have clearly tried to make sure that those existing Fannie and Freddie securities do not get orphaned in this transition period. And you suggested, I believe, in your written testimony a phased-in approach that would allow the new security to be blended with existing Fannie and Freddie credits that are out there, to make sure that we do this continuity. Do you have any other specific comment on that? It is an interesting idea, and I have not really thought——

Mr. HAMPEL. Yes, what we had in mind is that—well, much of the functions that are now performed by Freddie and Fannie should end up, some of them being with the Federal Mortgage Insurance Corporation and some of them with the Mutual, the issuer—the two functions being split, the guarantor and the issuer. And in the process—in a perfect world, when this is all said and done, when we have flipped the switch, no one will really notice anything happening that day because it happened gradually through time. And so as much as possible, if certain functions are going to be transferred from the old entities to the new entities, that it be done in as seamless a way as possible. And in terms of the securities, it would just mean that if the securities from—the FMIC-backed securities are going to end up being somewhat different from the current structure of Freddie and Fannie, that those Freddie and Fannie structures be changed along the way so that, again, there is as seamless as possible a transition.

Senator WARNER. You actually have a blending of kind of a mix——

Mr. HAMPEL. Yes.

Senator WARNER. ——of the securities together so there would be that transition. I would love to see more comments on that.

Mr. Swanson, I guess one of the things I am very interested in trying to work through the role, the very important role that the Federal Home Loan Banks play in what we hope would be this new system, we hope they would play an important role, as an aggregator or potential issuer, how would you make sure—you know, since you represent—do a great job, but on a geographic area that we get the appropriate geographic diversity when you in a sense see the home loan bank boards issuing together and then coming through a single platform, putting their product then through the Mutual, do you want to talk about that on geographic diversity?

Mr. SWANSON. It is a great question. There are 12 Federal Home Loan Banks. We are each independent. That is one of the strengths, but it is also one of the challenges when you are trying to address a national problem.

Today we have one type of program that now 10 banks are either offering or they are in the final stages of getting approval to offer. That is the MPF program. It is operated through a common provider at the Chicago bank, but the actual business activity is done by each of the participants in that program. Two other banks operate a slightly different program called the MPP program, so we anticipate by the first part of 2014 that all banks will be offering some form of mortgage program in their areas.

Senator WARNER. But then if they do this, we would have to still figure out a way for your role so that if this basket of securities would not just be limited to a certain—one particular geographic region.

Mr. SWANSON. Yes, and we do not necessarily envision ourselves being an issuer of securities. It is a possibility depending on how the overall market evolves. But I think it is likely that if our business expands, each bank may operate—may handle its own balance sheet, and then have a centralized process where we would handle the aggregation and pooling to get economies of scale.

It is also possible—and we have been in contact with the staff about some technical corrections in S.1217—that we would form through multiple banks or all of the banks together some form of subsidiary to do this.

Senator WARNER. My time has run out, Mr. Chairman, but I just—and I will not ask for any response, but I would like to hear from all of you—you know, there is a tension here as we think about transferring some of the assets from Fannie and Freddie over to a Mutual, you want them all transferred as cheaply as possible. We also have to look in terms of protecting the rights of the taxpayer. But if you can give us some more specific comments on that, that would be helpful.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and thanks again for having these weekly hearings, and thanks to all the witnesses. I know you have not only participated today, but I know you have been participating with the Banking staff and with all of us who are concerned about getting a new housing finance system.

Let me just sort of get some general themes, if I could. If I understand correctly, all six of you like the idea of a Mutual being created, and, you know, the issue of how it is capitalized, I think we all understand, since it is not taking risk, we are not talking about something that has to have a large amount of capital. It is basically just working capital, as I understand it.

The notion or the figuring out of how we get that small amount of capital into the Mutual in advance is an issue that certainly like minds can figure out a way of doing. So it is an issue we need—it is a detail we need to figure out, but you all do not see that as something that is very difficult to do. Do you all agree?

Mr. HAMPEL. Right, yes.

Senator CORKER. So the body language is all in acknowledgment.

The G-fees for volume, another interesting prospect of S.1217 is that we move away from volume-priced G-fees and instead it is on a per loan basis, and if I understand the testimony and the private meetings we have had, all of you think that construct of having G-fees based on a per loan basis versus volume is also a concept that is a good one. Is that correct?

Mr. HAMPEL. Correct.

Mr. COSGROVE. Yes.

Senator CORKER. And then a third concept would be separating the common securitization platform from the risk sharing. Right now, let us face it, Fannie and Freddie own those, if you will, and it does make them, if you will, no question, too large to fail, because if they failed you would not have that common securitization platform. So the notion of separating the risk taking from the common securitization platform is also an idea that all six of you seem to embrace. Is that correct?

Mr. LOVING. Correct.

Mr. COSGROVE. Yes.

Senator CORKER. OK. So it seems to me that—I know there are some details that all of us need to work together to get to a good end, but it seems to me on the big ideas we are there. And I know there are some questions about, you know, who should be a part of the Mutual and how the voting should take place. And, again, it seems like to me those are important details, especially from your perspective. But they are things that we can figure out.

The transition, I agree, we need to add some meat to that, although I think giving the FMIC Director and others a little bit of leeway probably makes some sense, too. You want some degree of judgment. You do not want us laying it out so ironclad that there is not some degree of flexibility, but we need to add some detail there. Is that correct?

Mr. LOVING. Correct.

Mr. COSGROVE. Yes.

Senator CORKER. OK. I noticed all six. So here is what I would ask. I noticed that there is—look, you know, I used to borrow a lot of money myself and, you know, in the beginning borrowed everything. And I realized that with, you know, no equity down, you can really make an infinite return on your investment. And I realized there is always, you know, a desire to water things down and make it easier to deal with these entities.

There are a couple of issues I would like to question. One is QM. I noticed that some of you have some concerns about QM being the standard, and I guess from our side, the concern we have is setting up an entity, and all of a sudden, the standards get so watered down that we end up creating a catastrophe.

Mr. Hampel, if you could, talk with me a little bit about it. I know 1217 now contemplates QM plus 5-percent downpayment. I know there have been some concerns about that being too rigid, not from the panel but from the witnesses, and I wonder if you might address that from your perspective.

Mr. HAMPEL. Thank you, Senator. The problem with any specific set of criteria as in the QM standard is that assessing whether or not an individual loan application is a good loan or not depends on so many different factors that it is hard to write a standard that draws bright lines for each of those factors. And so a 43-percent debt-to-income ratio in most cases is really a reasonable standard. But there can be cases when other factors will make that no longer necessary.

The other thing is that coming as we do after the worst financial crisis in the last 80 years, it is understandable that the rules that people would think are appropriate now are probably a little bit stricter than they really should be, just because we are recovering from such a crisis. And we fully understand how we do not want to set up something where the standards can deteriorate so that 20 or 30 years from now we are back to where we were.

But, on the other hand, setting in place strict criteria with bright lines on various of the many subcategories of making a loan could have the effect of excluding a lot of otherwise qualified buyers from mortgages, and probably more of the excluded people will be on the lower end of the income distribution, which is probably not a good thing.

Senator CORKER. Mr. Chairman, I see that my time is up. I would like to talk with you all a little bit more deeply about how we go about that. You know, those of us who care about the taxpayers, which is all of us, I think, we do not want this thing watered down and Congress playing in this thing again and getting us in trouble. At the same time, I think some of the points you are making are good, and you never ask a witness a question that you do not know the answer to, and so I am not going to do that publicly, Mr. Hampel. But I do want to follow up a little bit on your countercyclical idea. I know the way it is right now we let the capital standard fluctuate downward if there is a disruption in the marketplace. I know you have contemplated something else.

By the way, I like all of your testimony. I just had time for one witness. But I do look forward to following up with you on both of those, and all of you, with your relative concerns. I appreciate the way you have worked with us. Obviously the Home Loan Banks have played a great role right now in housing, and I know we add some responsibilities, and we look forward again to working with all of you as we move ahead.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman. I appreciate the comments of Senator Corker. Thanks to all six of you for testifying today. You all raise important questions about what structure might work. Your testimony, unfortunately, also illustrates the complexity of this and how this is going to be no easy—there are going to be no easy answers.

I appreciate the Chairman's question and your response about the importance of getting this right and the importance of moving not too quickly to get it right. I think that is particularly important.

Let me just ask one question. I will start with Mr. Cosgrove as a fellow Clevelander, but I would like this answer from all of you. The mortgage market, as we know, is fairly concentrated in both origination and servicing. The five largest servicers service more than half of all mortgages; the two largest originators make up more than 40 percent of all new loans.

Mr. Cosgrove, and then each of you starting, if you would, from left to right, what does this mean for small institutions? You said you have some 200 employees in Strongsville and elsewhere?

Mr. COSGROVE. Right.

Senator BROWN. If you would start and just give me your thoughts on what this means for relatively small institutions like yours.

Mr. COSGROVE. Well, Senator, it is highly—this issue is highly important for small lenders. We all know the old system. Although there are many good parts of the old system, the old system also exasperated—the differences in G-fees was a major point in that, and what happened over time is smaller lenders, if you do not have transparency in a system, if you do not have parity in the price of the risk, if you do not have parity in that area over time, the concentration gets to the top of the market. And at the end of the day, companies like mine need to have the ability to compete on what is right, and what is right is measuring the price of the risk of the loans. And if you do a good job with your customers and they have the ability to repay and you are doing the right thing, you should be rewarded for that. And I think the system today that is being contemplated answers a lot of those questions moving forward, and we are excited about that. We are also excited about, in 1217, when they talk about the Mutual, you talk about us potentially having access to the Federal Home Loan Bank System, we need multiple single-loan cash window, we need multiple—small lenders, multiple options to execute our loans. And if we have those options, we are going to have the ability to compete, the ability to give our consumers very good pricing, which is good for competition and good for the marketplace, and gives us the ability to compete nationwide. So we are excited about that.

Senator BROWN. Mr. Swanson, any comments? If you have something to add, any of you. Thank you, Mr. Cosgrove.

Mr. SWANSON. I would make two quick comments. The Federal Home Loan Bank of Des Moines serves a part of the country that is largely rural, agricultural, small towns. The importance of smaller lenders, community banks and other lenders, in serving that market is absolutely essential. It would not be served otherwise.

The other point I would like to make is that large lenders tend to commoditize their business, commoditize their mortgages, so that there is less flexibility in underwriting the needs of the kind of customers that Bill and others on the panel have talked about. Having a system where small lenders can really underwrite the specifics of a particular borrower and a particular home or property is absolutely critical.

Senator BROWN. Mr. Loving, before you answer this, I want to ask you another question so I can get one more question in, if I could. There are two ways to level the playing field, obviously, for small institutions: either help them pool their resources or set some—so they have some same scale as megabanks perhaps, sort of limit the scale and scope of the largest banks. You talked about a 15-percent limit on a single securitizer. So answer that, if you would, as we go down the——

Mr. LOVING. Well, again, I think it is important that we have volume so that there is a scale of efficiency and pricing. But the fear would be that if the opportunity was there without a cap, there may be a concentration in the market that you were just speaking about in your previous question on the servicing side.

So we think it is important that there be an opportunity to participate, but yet at the same time, we want to cap that level of participation so that there is somewhat of an equal or level playing field in the ownership.

Senator BROWN. Thank you.

Mr. Hampel.

Mr. HAMPEL. We think if you provide smaller lenders the opportunity to pool their resources to create a utility large enough to meet their needs, then it would not really be necessary to restrict the size of any other players.

Senator BROWN. OK. Mr. Harwell.

Mr. HARWELL. We think small lenders need guaranteed access and fair pricing based on quality because we do not have the ability of the large lenders to securitize and get volume pricing.

Senator BROWN. OK. Mr. Plagge.

Mr. PLAGGE. A lot of it has been covered. I think the other thing that we want to make sure we cover in this transition is just the operational size of making mortgages. There is a lot of change going on with mortgage reform today, and systems will really matter. There are some great systems out there being used today, and we want to make sure those systems are available to lenders of all sizes to make sure we do not have that disruption even at the lenders' desks themselves. And access pricing and all the things that have been mentioned are very critical. In some markets that we serve, we are the mortgage lender. And so if we are not there, that market gets underserved pretty quick.

Senator BROWN. Thank you.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Heitkamp.

Senator HEITKAMP. Thank you, Mr. Chairman, and thank you to Mr. Swanson, who does great work in my home State of North Dakota, which tends to be extraordinarily rural, and participates in helping us capitalize and provide access to home ownership in our State.

I want to just tell you I have a particular interest in this, which is making sure small institutions are able to participate in mortgage lending to begin with before you can even get into the secondary mortgage market. So I want to just kind of put that on the table as well.

You have heard a lot of kind of back-and-forth here, I think, on the panel with the Senators on what is the appropriate timing, what do we see, and I think it is really quite remarkable that you are all coming with about the same level of suggestions. And it is, I think a tribute to the great work that has been done by Senator Corker and Senator Warner in vetting this process to begin with, and I think the work that the Chairman and the Ranking Member have done to bring folks together over a period of time.

And so where I think we can all agree, it is critically important that we get this right. I think that the changes that we want to make are important, but not insurmountable, and so I am just—you know, I always hate to nail timeframes down, but do you think this is a year's worth of discussion, 2 weeks' worth of discussion, 2 months' worth of discussion, to basically address the concerns that you have raised today? And I would ask anyone on the panel to answer.

Mr. LOVING. I am not sure if you can define it as a specific time line, whether it be months or weeks or a year. But I think it is critical that the process that is taking place today and that has taken place, I think it is critical that the end result in the perfect result, that it fits all the markets.

[Laughter.]

Mr. LOVING. And I know that is a big ask, but I think it is important that it be processed and it is done correctly at the end.

Mr. PLAGGE. I might just add I would agree with the urgency side that Senator Warner talked about as well. We have an entities today that are in conservatorship, no capital, no ability to raise capital. So there is a time element to that that I think needs to be pressed. And I just so appreciate the Committee's open discussion on this because it is going to be some back-and-forth and some testing and flexibility along the way, but I think we can get to the right solution, and sooner probably rather than later.

Senator HEITKAMP. Within a reasonable period.

Mr. PLAGGE. Right.

Mr. SWANSON. Senator Heitkamp, I have to tell you I am torn between two feelings. One is I very much agree that this is a window and prompt action is really important. I think it is important to give some certainty about the direction that this is going to head. But I can also tell you, it is complicated. I think all of us are engaged in much deeper conversations outside of this room today than we were a month ago. And I think those conversations do need to continue as we build out the details. It will also take some time to transition once a decision is made from the system we have to a new system, and that is really important to think about.

Mr. COSGROVE. Senator, I see this almost as two wheels spinning. You have the wheel spinning of the legislation from this body that we have come a long way and is well thought out and I think is moving at a very good, reasonable pace. And then you have the other spinning wheel of the reality of being a market participant and creating the capital markets, obviously, and making sure that there is a smooth transition to the funding mechanisms and making sure there is no disruption to the real estate industry, to our consumers, understanding where the housing recovery is at today.

So I almost see this as two spinning wheels, both legislatively and the realities of the capital markets and serving customers, along with the other items that are being dealt with in the marketplace like QM that is about to take off in January and other things like that.

So I think we are going at a very reasonable pace right now, and I think it is a good thing where we are headed.

Mr. HARWELL. We think it is important to get it right more than it is to do it fast, although we do believe that we are getting close on agreement.

Senator HEITKAMP. OK. And I have a couple other questions I will submit for the record, but I think it is important to understand that there is a level of frustration among a lot of folks out there that we continue to talk about reform, but we never do reform. We somehow never seem to get it done because we hesitate. And I think if you look at transition rules and the ability to adjust during a transition period, I think that is a critical component. And to the extent that you can provide input on that transition so that we have safeguards at various points along the way, I think that would be very helpful.

But I will tell you that this is a town that does not move very fast and they do not respond to crisis very well, and, you know, I can only imagine if this was the Congress that has to fight World War II where we would be.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman, Ranking Member Crapo. I think it is clear we all agree that small lenders need access to the secondary markets so they can write more mortgages and they can get funding that they need through advances from the Federal Home Loan Banks. And those advances play a critical role in promoting home ownership, particularly, I think a recent study showed, in rural areas.

I think it is also clear that the market believes that the obligations of the Federal Home Loan Banks are implicitly guaranteed by the Government, which is part of how these banks can raise funds at very low rates and then lend those funds at below-market rates.

Now, that may work if the funds are going to support hospital in an underserved area like inner cities or in rural communities, but not every home loan bank advance goes to support home ownership, and every dollar that is used for another purpose is a dollar that is not available to finance the purchase of homes.

One example of that is the multi-billion-dollar loan that Mr. Swanson's institution, the Home Loan Bank of Des Moines, has extended to a Sallie Mae subsidiary at an interest rate of about one-third of 1 percent.

Now, as you all know, Sallie Mae is a private not Government company that made nearly $1 billion in profits last year, primarily by making high-rate private student loans, loans that have been documented to decrease home ownership.

Now, I have no doubt that Sallie Mae subsidiary in question meets the legal eligibility requirements to be a member of the bank, but I have some underlying—some concerns about the underlying policy about how mutuals work here.

So first I have a specific question about Sallie Mae, and that is, in past SEC filings, Sallie Mae has mentioned the credit facility from the Home Loan Bank of Des Moines, but it does not mention the credit facility in its most recent SEC filing.

So, Mr. Swanson, does that mean that your bank has stopped lending to Sallie Mae?

Mr. SWANSON. Sallie Mae is a member of our bank through an insurance company that is a subsidiary or affiliate of it. We do not have any responsibility for their SEC reports——

Senator WARREN. I was not asking that question. I was just asking you a simple question. Have you stopped lending—you had a multi-billion-dollar loan——

Mr. SWANSON. They are still a member of our bank, and they still have the ability to borrow, assuming that they provide federally guaranteed student loans as sufficient capital for their borrowings.

Senator WARREN. So let me ask you about that, about the activities that your bank supports and that it does not support. Is there a clear line between what it is that you can support and what you do not support?

Mr. SWANSON. There is. There are two parts to the question. One is who can be members, and Congress——

Senator WARREN. No, that one I understand.

Mr. SWANSON. ——establishes that. And then the second point is when members borrow from us, what kind of collateral is eligible for them to pledge to us? And our primary source of collateral is home loans. We also take other forms of commercial real estate, including multifamily. And then we are permitted under our statute to take Government-guaranteed securities. And in the height of the liquidity crisis and economic crisis—in fact, it was early in 2008, Congress through a resolution in the House actually asked the regulator of the Federal Home Loan Banks to determine whether——

Senator WARREN. I am sorry, Mr. Swanson, but——

Mr. SWANSON. ——we could help with that liquidity.

Senator WARREN. ——I am really going to be limited on time. I know what law is here. I just want to ask the question. In terms of the activities that you support, you are saying it would be for home loans and for student loans, but just so I can draw a clear line here, because we searched your Web site and we are trying to get clear on this. It would not be, for example, for other loans, to support other kinds of retail business, to support payday loans, to support tobacco stores, to support other kinds of activities. Is that right? You are telling me that is the clear line, only student loans and real estate loans?

Mr. SWANSON. Our regulation and statute controls the collateral that we take for loans, and Congress further expanded the collateral for small institutions to include agricultural loans and small business loans. But that is pretty much the menu of collateral that we can take. Very restrictive.

Senator WARREN. And so you will not lend in other areas and other business activities. Is that right?

Mr. SWANSON. We cannot lend on any other types of collateral.

Senator WARREN. The reason I raise this is because I think it is important, if we are talking about mutuals and our investment, in effect, in the housing market in mutuals, to know exactly what activities would or would not be covered by that, how much of it would go to housing and how much might be going to other things.

I see that I am out of time. I am going to submit another question for the record, but I just want to say it is a question about whether or not mutuals will be able to compete in a highly concentrated industry. I think we are all aiming in the same direction, and that is that small banks have access, perhaps through a mutual structure, to be able to get money. But that has much higher administrative costs than a very concentrated banking industry where you have got an issuer who can lend to itself or to a small number of other issuers where you have got issuers and the—when there is much more concentration, it is much easier to cut down on the costs. And so I am just going to have a question about that, but I will submit it for the record. Thank you.

Chairman JOHNSON. Senator Manchin.

Senator MANCHIN. Thank you, Mr. Chairman.

To Mr. Loving, good to see you, Bill. As we know, West Virginia is a small lender market like a lot of other States throughout the country, and in States like ours, West Virginia and the smaller nature, the rural that are not always served by the larger financial institutions, how do we ensure that all of our constituents and all of our people back home are going to have access to the options from institutions like yours and to ensure that the regulation is structured so that the smaller lenders and smaller populations are not placed at a competitive disadvantage?

Mr. LOVING. Thank you, Senator, and it is indeed a pleasure to see you. I think it is important that the structure and the regulations that come forth from the Mutual is set forth so that the underwriting guidelines can be used in all markets, particularly if you are talking about West Virginia and other rural markets. There is a particular type of housing option, which is manufactured housing, that is—it is an affordable option for many people not only in West Virginia but across America.

Unfortunately, underwriting guidelines as they currently exist will not allow the approval of a manufactured home, and so that puts many individuals, constituents, in rural America at a disadvantage.

Now, there are community-based banks that portfolios products, and they are very good options and investments for us. You know, as we have always said, we are relationship lenders. We know the borrowers. We know where they are located. And so it is a very acceptable risk, and so I think it is important that we set forth regulation and guidance in underwriting that allows access to all types.

Senator MANCHIN. Let me see if any of you want to answer this one basically on the 10-percent deductible that must be paid by the private markets. Do you think that is adequate? Too much? Not enough? Overkill?

Mr. COSGROVE. Senator, we believe that it is too much. If you look back, even in the height of the crisis, we believe a 4- or 5-percent capital ratio would have been sufficient to get us through at that period of time. So we believe the 10 percent is too high and could restrict——

Senator MANCHIN. You know, we are a little bit skittish right now because of putting the taxpayers on the hook again. We seem to have jumped on that hook before. But I am just hopeful that you are able to be a little bit more expert—have an expertise that would help us to get a figure that is going to be adequate, not one that you would like but one that you know will do the job and keep us out of danger.

Mr. HAMPEL. Senator, 10 percent on any single mortgage or any security is not too much, but requiring the bond guarantors to put up enough money to have 10 percent of their entire exposure would be too much. There is not 10 percent of the total amount of securities that would end up covered—you know, that much capital is an enormous amount of capital, and——

Senator MANCHIN. You all agree that we were undercapitalized—I mean, we were——

Mr. HAMPEL. Absolutely. Absolutely. But having on any mortgages 10-percent coverage from the private sector before the 2.5

percent of the FMIC would come in, that is providing, with a 20-percent downpayment, 32.5 coverage for the taxpayer, which is probably——

Senator MANCHIN. I think those of us who have signed as cosponsors of the bill are more than willing to look at something that is reasonable and that can be done and that is going to be protective, and give us your reasons. If you could submit that, that would be very helpful. There is a basic question that has been alluded to but not answered directly. And the Warner-Corker bill, S.1217, as it has been drafted, do you believe it is the right direction to go for our country? Do you believe it is the right direction to go for our financial institutions and that it will do a much better job than Fannie and Freddie that we are going to be replacing?

Mr. SWANSON. We are an organization that is actually chartered by the Government, and it is not appropriate for us to take a position on any particular bill.

Senator MANCHIN. Bill.

Mr. LOVING. I think the components of S.1217 certainly move in the right direction. I think as we look toward tweaking, if you will, some of the components of the bill, I think it certainly is moving in the right direction.

Mr. HAMPEL. We have suggested improvements, but in general, yes.

Mr. COSGROVE. We believe so as well, Senator. We believe that the options beyond the Mutual need to be expanded, but, you know, as long as that takes place, we believe it absolutely is headed in the right direction.

Mr. HARWELL. We believe it offers a workable solution, with some tweaks.

Senator MANCHIN. Jeff.

Mr. PLAGGE. We absolutely agree. We think compliments to the Committee for being so open on the discussion and, you know, the access, the pricing, the whole process, and not only on the front end of the conversation but welcoming us to further conversation.

Senator MANCHIN. Have you all had—and my time is up. Have you all had input basically with the sponsors and all the people working on the bill right now?

Mr. PLAGGE. Yes.

Senator MANCHIN. Have they been receptive to your suggestions?

Mr. PLAGGE. Very much so.

Senator MANCHIN. Thank you.

Chairman JOHNSON. Thank you again to all of our witnesses for being here with us today. I also want to thank Senator Crapo and all of my colleagues for their ongoing commitment to protecting small lender access to the secondary mortgage market.

This hearing is adjourned.

[Whereupon, at 11:34 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF RICHARD SWANSON

President and Chief Executive Officer, Federal Home Loan Bank of Des Moines, on behalf of the Council of Federal Home Loan Banks

November 5, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, I am Richard Swanson, president and CEO of the Federal Home Loan Bank of Des Moines. Thank you for the opportunity to speak to you today on behalf of the Council of Federal Home Loan Banks (Council), an association representing all of the Federal Home Loan Banks (FHLBanks).

The 12 regional FHLBanks are member-owned cooperatives with over 7,500 member financial institutions—of all sizes and types—nationwide. The Federal Home Loan Bank of Des Moines ("FHLB Des Moines" or "Bank") is a valuable and reliable partner to nearly 1,200 community lenders throughout Iowa, Minnesota, Missouri, North Dakota, and South Dakota. (Please see Attachment 1 for an in-depth overview of the FHLBanks.)

At the outset, you are to be commended for the thoughtful and deliberate approach being taken by the Committee to reform and restructure the mortgage finance system. This is a complex task that will have far reaching impact on a sector of the economy that dwarfs most others. Some estimates place housing's share of the economy at over 15 percent.[1]

The Committee's focus today on protecting small lender access to the secondary mortgage market is well placed. For the past 25 years, I have devoted my career primarily to the success of small financial institutions in meeting the housing finance needs of the communities they serve, first as the president of a community bank and now as the chief executive officer of a cooperative wholesale bank that provides low cost funding and liquidity, as well as secondary market mortgage support and other services, to its 1,200 members—almost all of whom would be considered "small lenders" by any definition.

When the FHLBanks were created by Congress in 1932, virtually all home loans were made by small lenders. Our central purpose then, as now, was to provide lenders access to a reliable and stable source of liquidity and funding so that they could meet the credit needs of their communities at all points in an economic cycle. For small lenders who originate home loans in excess of what can be held in their own portfolios (i.e., as assets on their own balance sheets), many of the FHLBanks have also provided access to the secondary market over the past 16 years. The FHLBanks' experience with their mortgage programs is certainly relevant to decisions that need to be made regarding the future of the housing finance system, and we are uniquely positioned to play an important role in the housing finance market of the future.

Recognizing that the focus of this hearing is on small lenders, it is important to keep in mind that the presence and active participation of members of all sizes and varied types, including thrifts, commercial banks, credit unions, insurance companies, and community development financial institutions, has been a key factor in the success of the FHLBank cooperative model. The FHLBanks can help ensure that financial institutions of all sizes have equal access to secondary mortgage funding nationwide so that their customers can obtain competitive market rate mortgage loans in all business cycles and their communities remain vibrant.

Why Are Small Lenders Important to the Housing Finance System?

With deep customer relationships, community lenders are natural mortgage lenders. Readily available access to additional sources of funding and the secondary mortgage markets strengthens the ability of community lenders to provide housing finance; likewise, the secondary markets are strengthened by the quality of mortgages originated by community lenders.

Community lenders remain significant players in housing finance, notwithstanding the continuing pace of greater concentration being observed in mortgage originations. The core strength community lenders bring to the market is their deep knowledge of local markets and their personal relationship with customers. In smaller communities and in rural markets, community lenders are often the sole source of mortgage credit as larger institutions typically focus on more densely populated areas.

While not having the dominant share of originations, smaller lenders originate a significant amount of mortgage loans. In 2012 there were 7,047 lenders with less than $1 billion in total mortgage originations, compared to 272 lenders above that

[1] National Association of Home Builders, October 2013.

amount. The lenders with total originations less than $1 billion accounted for approximately $528 billion, or 26 percent of the market last year. [2]

What Do Small Lenders Need To Serve Their Customers and Communities?

From the FHLBank Des Moines experience in assisting smaller lenders in the mortgage markets, community lenders need the following to serve their customers and communities:

- The ability to provide a range of mortgage loan products to meet customer needs in all market conditions:
  - Although some loans, such as adjustable rate and balloon mortgages, can be held by small lenders in their own portfolios, these lenders may need a source of funding for those loans other than customer deposits.
  - Other mortgage loans, including long-term fixed-rate loans, are not usually retained by smaller lenders due to the difficulty of managing the interest rate risk these prepayable loans present.
- Access to the secondary market on terms fair to small lenders.
- Pricing of their mortgages based on the credit quality of the loans they make, as opposed to the quantity of loans they sell.
- The ability to sell mortgages to the secondary market on a single-loan basis that is impartial, efficient, and provides equitable pricing for community lenders. Most community lenders do not originate sufficient volume to pool and/or securitize their mortgages.
- The ability to service their mortgage loans or to sell servicing of their mortgages on reasonable terms to a party who will provide excellent service to, without competing for, their customers.

How Do the FHLBanks Help Small Lenders Provide Home Loans?

The FHLBanks help small lenders provide mortgages in many ways:

- The FHLBanks provide cost-effective, flexible funding for loans that small lenders hold in portfolio, including funding for adjustable rate and balloon mortgages, as well as long-term fixed-rate loans. Managing the interest rate risk involved in longer-term fixed-rate loans is challenging, and the FHLBanks offer a variety of advance products to meet the needs of these lenders. Members can obtain long-term fixed-rate funding to match the mortgages held in portfolio. Amortizing advances are available that can be matched to a portfolio of mortgages the member holds. Advances are also available that allow members the option to prepay the advance without a fee to manage the interest rate and prepayment risks of the member's mortgage portfolio.
- The FHLBanks offer mortgage programs that enable smaller lenders to sell long-term fixed-rate loans on reasonable terms. With the development of the securitization market since the creation of the FHLBanks, the majority of mortgage loans in the United States are now pooled into securities that are held by investors throughout the world. While providing funding and liquidity to members through advances remains the core business of the FHLBanks, supporting the success of members by offering them access to the secondary mortgage market is another way that the FHLBanks have fulfilled their mission.
- When a community lender originates and later sells loans to secondary market investors, the FHLBanks may provide warehouse lending, funding the loan between the time the loan is closed and the loan is sold.
- The FHLBanks also provide technical assistance to members in understanding how to quantify and manage the interest rate risk from holding mortgage loans, as well as in documenting and underwriting loans so that they qualify for sale to the secondary market.

What Challenges Did Small Lenders Have Before the FHLBank Mortgage Programs?

Prior to the FHLBank mortgage programs, community lenders had three choices when originating conventional, fixed-rate mortgage loans, each of which presented significant challenges for small lenders:

- One option was for community lenders to hold the loans to maturity on their own balance sheets. Although holding loans to maturity on their balance sheets enabled community lenders to retain customer relationships through loan serv-

[2] All data is from HMDA.

icing, this option presented community lenders with difficulties in properly funding and hedging the interest and prepayment risks of long-term fixed-rate mortgage loans at a cost competitive with secondary market alternatives.

- Alternatively, the community lender could sell conventional, fixed-rate loans to the secondary market. However, when selling loans directly to Fannie Mae and Freddie Mac, smaller lenders were disadvantaged by having to pay higher "guarantee fees" than larger lenders. The guarantee fee structure rewarded high volume lenders, and further disadvantaged smaller lenders by not compensating them for the superior credit quality and performance of their loans.
- Community lenders could also sell loans directly to a larger financial institution which would aggregate mortgages from many smaller lenders and sell them to the secondary market. Under this option, while the larger institution might receive the benefit of a volume discount from Fannie Mae or Freddie Mac, this discount would not necessarily be passed on to the small lender. This option often resulted in unfavorable pricing to the small lender as a result of increased transaction costs. This option also had the further disadvantage of providing a potential competitor the opportunity to solicit customers from the smaller lender.

The FHLBank Mortgage Programs

For the last 16 years, the FHLBanks have been providing members with secondary mortgage market options through our MPF and MPP mortgage programs. The FHLBanks have filled a need in the secondary mortgage market by providing a competitive outlet for the sale of high quality mortgage loans originated by community lenders. These programs give participating members access to the secondary market through several channels:

- Mortgage Partnership Finance® (MPF®) Program—The MPF program involves the purchase of qualifying conventional loans and Government-insured loans by participating FHLBanks. This program offers a variety of risk sharing arrangements (skin-in-the-game) while allowing Participating Financial Institutions to continue to manage all aspects of the customer relationship. The program was created by the FHLBanks to fill a need in the secondary mortgage market for community lenders who were unable to sell mortgages at prices that reflected their superior credit quality. The MPF Program operates on the premise that by combining the credit expertise of a local lender with the funding and hedging advantages of a FHLBank, a stronger, more economical and efficient method of financing residential mortgages results.
- Mortgage Purchase Program (MPP)—Similar to the MPF program, the MPP program provides members the ability to sell conforming loans at a competitive rate with the potential to recognize additional revenue if the loan performs well. Under the MPP program the FHLBank is protected against credit loss through a feature called the lender risk account (LRA), which again serves as the member/seller's "skin-in-the-game." Under the LRA, funds are set aside to cover potential loan losses. If the funds are not needed, they are returned to the seller over time. The seller has the potential for a higher all-in return if it originates and sells mortgages of high credit quality.
- MPF Xtra® Program—The MPF Xtra program allows members to sell their loans through participating FHLBanks to Fannie Mae at a more favorable price than they could obtain individually, but without any risk sharing obligation. This pass-through service, by which members benefit from a form of volume discount, complements the other FHLBank mortgage programs.

By using the FHLBank mortgage programs, community lenders have the ability to:

- Gain more favorable access to the secondary market, since the FHLBank mortgage programs are designed primarily for smaller lenders.
- Control the origination and underwriting process.
- Engage in a business relationship with a secondary market partner that is a cooperative in which they have an ownership interest as well as a voice, rather than with a potential competitor for their customers.
- Offer competitive mortgage pricing to their customers in spite of their smaller size and volume.
- Retain a small portion of credit risk in their loans (skin-in-the-game) while transferring the interest rate, prepayment and liquidity risks to the FHLBanks.

- Increase their income by receiving future credit enhancement fees based on the credit performance of the mortgages they originate.
- Determine whether to service their mortgages or transfer the servicing to a non-competitor that has been prequalified as a servicer by their FHLBank.
- Preserve their customer relationships.

The FHLBanks' MPF and MPP mortgage programs have proven to very popular with FHLBank member institutions and have provided great value to them. The credit history of the programs has been exceptional. Following is a summary of their performance over the past 16 years:

- Over 1,500 member institutions, located in all 50 States, have used one of these programs to provide mortgages for their customers. Of these members:
  - 70 percent have assets of $500 million or less;
  - 30 percent have assets of more than $500 million.
- The median size of these mortgages is about $135,000.
- The credit quality of mortgage loans funded by FHLBank members has proven to be excellent. The programs have experienced extremely low losses, particularly conventional loans funded through a program that uses a risk sharing structure that ensures member lenders keep "skin-in-the-game."
- Of the $202.5 billion in conventional mortgages funded through either the MPF traditional program or the MPP program since their inception, only $303.6 million of losses have been realized, as of June 30, 2013. This represents a loss ratio of only one-fifteenth of 1 percent—0.15 percent or 15 basis points.
- Only 1.78 percent of these loans were 90 days or more delinquent, or slightly more than half of the national average of 3.24 percent. [3]

The very low level of credit losses (15 basis points) sustained by FHLBanks and their participating members since the beginning of these programs is truly remarkable considering it includes the period of time when the most severe economic stresses in the housing and credit markets in over 80 years were experienced.

The FHLBank risk sharing mortgage programs are built on the foundation of sound underwriting by our members who originate high quality mortgages from customers they know. Consistent with secondary market conforming loan requirements, the mortgages purchased through these programs are required to have loan-to-value ratios (LTVs) not greater than 80 percent of appraised value at origination, either through downpayments or mortgage insurance. In addition, these loans were made by community lenders who have the best interests of their retail customers in mind. As a result, most community lenders have such confidence in the credit quality of the loans they make that they are willing to share the credit risk associated with their own mortgage originations.

I would like to briefly describe my Bank's experience with credit risk sharing. The way the credit risk sharing works under the MPF Traditional 125 program, for example, is that the first layer of losses for each Master Commitment is paid by FHLB Des Moines up to the amount of the First Loss Account (FLA) which is 1 percent of the delivered amount of loans in the Master Commitment. The member institution that originated the mortgages then provides a second loss credit enhancement obligation (CE Obligation) for each Master Commitment. On average this is about 4 percent of the delivered amount of loans. To the extent that losses do not exceed the FLA, the member institution is compensated for retaining a portion of the credit risk and receives a monthly credit enhancement fee from FHLB Des Moines. Loan losses beyond the first and second layers are absorbed by FHLB Des Moines.

The following is a typical example of how the credit risk sharing functions for a member of FHLB Des Moines: A community lender in eastern Iowa has been a FHLB Des Moines Participating Financial Institution since 2004. Over the past 9 years this institution has sold the Bank 3,481 mortgage loans for a total of $393 million. The average loan size is $112,000. The member institution services these loans and to date has received $2.1 million in cumulative servicing fees plus an additional $965,000 in credit enhancement fees (reward for having skin-in-the-game). These fees continue to accumulate over the life of the loans. If the institution had sold those same loans to any other investor it would not have received the credit enhancement fee of almost $1 million of noninterest income. Only $13,000 in losses have been realized to date on the nearly $400 million in mortgage loans for which this member retains "skin-in-the-game." These losses were covered by FHLB Des

[3] As reported by the Mortgage Bankers Association's National Delinquency Survey for June 30, 2013.

Moines through the First Loss Account (FLA), but reduce future credit enhancement fees to the member.

What Do Small Lenders Need To Succeed in a Reformed Secondary Mortgage Market?

Under any mortgage finance reform proposal, including S.1217, two fundamental challenges must be met if small lenders are to be able to compete successfully and serve the needs of their customers and communities.

- First is the challenge of small loan volume. How can a few loans made each month by many community lenders be sold to the secondary market on terms that are competitive with large volume lenders?
- Second is the challenge of obtaining fair pricing for the value of mortgages that come from community lenders. How can small lenders receive better pricing for their mortgages if they demonstrate better performance, and therefore have higher value to secondary market investors?

The FHLBanks can play a key role in helping meet both these challenges.

How Can the FHLBanks Support Small Lenders in a Reformed Secondary Market?

Depending on how the legislation is finally structured and accepted by the marketplace, the FHLBanks could play an even larger role in helping smaller lenders successfully access the secondary market.

Addressing the Challenge of Volume

Building upon the deep relationships we already have with our members, the FHLBanks have demonstrated the capability of aggregating small origination volumes from many lenders to produce an overall combined volume that can be competitively priced in the secondary market. The FHLBanks have the potential to further support their members as an intermediary to the secondary market of the future in the roles of aggregating, pooling, and sale or securitization of member mortgages.

So far our mortgage programs either purchase loans from members to be held to maturity on the balance sheets of the FHLBanks, or they enable a pass through sale by members directly to the secondary market. In a reformed secondary market, Fannie Mae and Freddie Mac will no longer dominate the aggregating, pooling and securitization functions. It appears these functions will be distributed among more parties, potentially including the FHLBanks.

By aggregating loans from our many members, and holding them on our balance sheets—not for long-term investment but for a sufficient time to enable pooling of sufficient volume for efficient and well priced issuance of mortgage-backed securities in the secondary market, the FHLBanks will be able to further improve the pricing of secondary market loans for our smaller members.

By purchasing mortgages from community lenders the FHLBanks would hold mortgages on their balance sheets for a period of time until mortgages acquired from multiple members could be efficiently pooled for sale or securitization into the secondary market. By serving this aggregation and pooling role, FHLBanks could utilize their unique qualities and competitive strengths to support their members in originating mortgages. At the same time, by selling pools of mortgages from their balance sheets into the secondary market at more favorable pricing than their members could obtain individually, the FHLBanks would roll over their portfolios and would not be as constrained by volume limitations or challenges in managing long-term interest rate risk.

The secondary mortgage market envisioned by S.1217 would allow for the FHLBanks to serve in such an expanded role as mortgage aggregators. This could enable the FHLBanks to provide significant additional benefits to their members in addressing the challenges of obtaining competitive secondary market pricing for smaller volume community lenders.

Addressing the Challenge of Value

In the reformed secondary market contemplated by S.1217, any pool of mortgages securitized with the backstop Government guarantee would have to obtain private capital insurance covering the first 10 percent of losses. Assuming that this private capital loss coverage is provided by multiple parties meeting the capital and other requirements of FMIC, we would expect to monetize superior value of loans we purchase from community lenders by obtaining competitive bids for that loss coverage. Pools of higher value mortgages should command a lower premium.

The cost of loss coverage might be further reduced if our members elect to retain part of the risk on mortgages they sell to their FHLBank as they do under our portfolio mortgage programs. Such a "skin-in-the-game" program might be very popular among smaller lenders if it results in an even better price for their mortgages or a credit enhancement fee if their mortgages perform well.

If the reformed secondary market does not provide for competition by qualified providers of private capital first loss coverage of securitized mortgages, it is likely to result in a secondary market that rewards loan volume and not loan quality. Assuming FMIC charges uniform premiums for all securities backed by the Government guarantee, the structure and regulation of the private first loss guarantors will be very important in order to assure competition that, in turn, will enable the FHLBanks to assist smaller lenders in receiving fair pricing for their mortgage loans.

Housing finance reform legislation should also ensure that FHLBank members who are willing to retain some level of risk for the performance of their mortgages can be rewarded for superior quality through lower private guarantor fees up front and/or credit enhancements fees paid over the life of the mortgages if they perform well. Building upon their existing "skin-in-the-game" mortgage programs, FHLBanks can perform a valuable function by facilitating the retention of some risk by smaller members on their mortgages to reduce the cost of private capital loss coverage, thereby allowing smaller lenders to be appropriately rewarded for the value of their loans.

S.1217—The Housing Finance Reform and Taxpayer Protection Act of 2013

We are pleased that S.1217 recognizes the importance of maintaining a role for institutions of all sizes in the housing finance system of the future, and contains provisions intended to preserve equal and reliable secondary market access for small and midsize community financial institutions to help maintain reliable access to mortgage credit throughout all parts of the country. We appreciate that the bill provides different options for the FHLBanks to serve their members as the housing finance system of the future evolves. With the support and guidance of our members, we are open to exploring opportunities to expand our support of community lenders. At the same time, we emphasize the paramount importance of maintaining and protecting our continuing role as a reliable source for our members of liquidity and funding through advances.

S.1217 has several features that could enable smaller lenders to be successful in providing mortgages in the future. The bill presents a hybrid solution that includes substantial private capital and a catastrophic Government backstop. This hybrid solution includes private capital for losses related to mortgage defaults; but, in times of financial crisis, when private capital is insufficient to absorb those losses, the Government would step in. Mortgage borrowers who benefit from the Government backstop would pay a fee to compensate the Government for potential losses. All non- Ginnie Mae, Government-guaranteed securities would use a common securitization platform which would produce a more liquid market, facilitate loan modifications in future downturns, give issuers operating flexibility at a low cost, and permit multiple originators to sell mortgages into single securities with access to the Government guarantee.

S.1217 also contains provisions that would substantially alter the regulatory framework of the FHLBanks. As introduced, S.1217 transfers the supervisory and regulatory functions relating to the FHLBanks from the FHFA to the FMIC on the "transfer date," which is 1 year after the date of enactment. One of the three offices within FMIC provided in the bill is an Office of Federal Home Loan Bank Supervision, headed by a Deputy Director appointed by the FMIC board, to regulate and supervise the FHLBanks.

Regulatory oversight of the safety and soundness of the FHLBanks' traditional liquidity and advance business on behalf of their members has little to do with the anticipated secondary mortgage market supervision and insurance functions of the FMIC. Accordingly the Council recommends that the FHFA's existing supervisory and regulatory authority with respect to the FHLBanks not be transferred to the FMIC. Instead, if the FHFA is abolished, the FHLBanks should be supervised by a stand-alone independent regulator governed by a board structure, the members of which reflect a balance of experience and knowledge, including housing finance and community lending.

Under S.1217, the FMIC is given extensive duties and responsibilities, including ensuring to the maximum extent possible a liquid and resilient housing finance market and the availability of mortgage credit while minimizing any potential long-term negative cost to the taxpayer. These broad responsibilities of the FMIC over the entire housing finance market, along with the wide ranging authorities accompanying them, could potentially create conflicts with, and could certainly overshadow and impede, effective regulatory focus on the FHLBanks. The FHLBanks and their members have experienced the adverse effects of regulatory conflicts in the past, in preFIRREA times, and believe that it would be unwise to repeat that experience.

Conclusion

Mr. Chairman, thank you again for the opportunity to appear before you today. I would be happy to answer any questions. On behalf of the Council, I look forward to working with the Committee as you continue your work on this important matter.

Attachment 1

Federal Home Loan Bank Overview

The FHLBanks were created in 1932 to support America's housing finance system through their member thrift institutions and insurance companies. Since that time, Congress has expanded the mission of the FHLBanks to include support for affordable housing, community development, and other forms of community lending and has expanded eligibility for membership in the FHLBanks from thrifts and insurance companies to commercial banks, credit unions, and community development financial institutions. Advances (fully secured loans to member institutions) represent the core of the FHLBanks' business. Members rely on the FHLBanks to provide competitive access to liquidity and funding across all economic and credit cycles. The readily available cost- effective liquidity and funding with specific terms and features enhances the financial strength of local lenders so that they can meet the housing finance and other credit needs of their communities through a range of products and services.

During the nation's financial crisis, when dislocations in the capital markets made funding from other sources difficult, the FHLBanks were a critical source of liquidity for U.S. financial institutions, preventing far greater losses and potential failures. To meet the sudden need for liquidity during the crisis, the FHLBanks provided increased funding to members of all sizes and in every part of the country by $370 billion - from total outstanding advances of $650 billion in the second quarter of 2007 to over $1 trillion in the third quarter of 2008. The FHLBanks were able to carry out this essential liquidity function for their members without government direction or requiring taxpayer assistance. It was a direct result of the way in which the FHLBanks are structured, operated and prepared in all conditions to fulfill their mission.

The FHLBanks' Unique Structure Have Enabled Them to Successfully Fulfill Their Mission Since 1932

The FHLBanks have been able to successfully fulfill their mission as a result of several unique characteristics: their cooperative structure; a scalable, self-capitalizing, operating model; broad participation by a diverse membership; and dependable access to a deep, liquid market for FHLBank debt.

Cooperative Structure

The FHLBanks have a unique structure, comprised of twelve independent cooperatives and the Office of Finance that issues debt on behalf of those twelve regional FHLBanks. The FHLBanks are overseen by an independent regulator, the Federal Housing Finance Agency (FHFA), established by the Housing and Economic Recovery Act of 2008 (HERA Act of 2008). Each FHLBank is a separate and distinct corporate entity with its own member/shareholder institutions and its own board of directors. While the FHLBanks issue debt collectively and are jointly and severally liable for the repayment of those debt obligations, there is no single controlling entity with responsibility for or authority over the FHLBanks. Each FHLBank operates independently under the authority granted by Congress through the Federal Home Loan Bank Act, as amended, and in accordance with the regulations established by the FHFA. Each FHLBank is registered with the SEC and files periodic financial reports and other information at a level of transparency comparable to other large public companies.

Each FHLBank operates within a district originally established by the Federal Home Loan Bank Board, one of the predecessors to the FHFA. Each FHLBank's capital stock can only be purchased by its member institutions. Each member must purchase the FHLBank's capital stock in order to become a member, and must maintain capital stock holdings sufficient to support its business activity with the FHLBank in accordance with the individual FHLBank's capital plan.

Scalable, Self-Capitalizing, Operating Model

The FHLBanks are built to be scalable - advance levels ebb and flow with credit cycles to match member demand. Since the height of the economic crisis, advances have declined by more than half as reduced loan demand and excess liquidity have reduced members' need for advances. The decline in advance levels, following their rapid expansion, demonstrates that the FHLBank model works as intended. Throughout this period, moreover, the FHLBanks have remained profitable and increased their combined capital ratios.

As cooperatives, FHLBanks are not subject to the growth imperative that often drives the decisions of publicly-traded corporations. Demand for advances expands and contracts with economic and market conditions and the FHLBanks' capital stock outstanding appropriately adjusts to these changes. Although the specific requirements vary based on each FHLBank's capital plan, an institution must hold a certain level of capital stock to be a member. In addition, a member must maintain "activity-based" capital stock in proportion to the amount of advances it has outstanding.

During periods of credit expansion, the activity-based stock requirement automatically provides additional capital to support advances growth. For example, in the recent liquidity crisis, the significant increase in advances was accompanied by the purchase of additional capital stock to support those advances, thereby providing additional capital to the FHLBanks in direct proportion to the increase in assets. This allowed each FHLBank to meet the liquidity needs of its members while preserving the safety and soundness of the cooperative.

An FHLBank's capital stock cannot be issued to or held individually by members of an FHLBank's board of directors, its management, its employees, or the public, and is not publicly traded. There is no market for FHLBank capital stock other than among FHLBank members. The price of an FHLBank's capital stock cannot fluctuate, and all FHLBank capital stock must be purchased, repurchased, or transferred only at par value. There are no stock options or other forms of stock-based compensation for FHLBank management, directors, or employees.

Broad Participation by a Diverse Membership

The membership of the FHLBanks consists of thrifts, commercial banks, credit unions, insurance companies, and community development financial institutions. At the end of the second quarter of 2013, the FHLBanks had 7,558 members, composed of: 951 thrifts; 5,132 commercial banks;

1,186 credit unions; 273 insurance companies; and 16 community development financial institutions.

The composition of the FHLBank membership closely approximates the composition of the banking industry: 88 percent of members have less than $1 billion in assets compared with 91 percent of all banks and thrifts and 97 percent of all credit unions industry wide. Typically, advance utilization rates are fairly consistent across asset size groups, though smaller institutions are currently funding a larger portion of their balance sheets with advances than larger institutions. Many of these smaller institutions have limited or no direct access to the capital markets other than through their FHLBank.

In addition to depository institutions, over 270 insurance companies are now members of an FHLBank. Insurance companies are significant members of the FHLBanks, representing almost 13 percent of outstanding advances. These members play an important role in the housing market by holding substantial amounts of single and multi-family mortgages and agency debt. Many insurance company members are also active participants in the FHLBanks' Affordable Housing Program (AHP) and the Community Investment Program (CIP) as an extension of their involvement in economic development activities.

The mortgage finance and community lending industry is broad and varied. This variety is crucial to both financial innovation and the diversification of risk across institutions of differing size, geography, charter, and business model. By providing equal access to liquidity, the FHLBanks support the current structure of the industry and this structure can be a source of stability and strength moving forward. As Congress looks to restructure the housing finance system in this country, all member types of the FHLBanks will have an important role to play in meeting the nation's housing finance needs.

Dependable Access to a Deep, Liquid Market for FHLBank Debt

The market for FHLBank debt is one of the most liquid. To the end investor, this liquidity represents an appealing characteristic. Collectively, the FHLBanks issue debt in significant volume on a daily basis. The size, frequency, and consistency of issuance mean that it takes less time for the market to absorb new issues during both normal and stressed markets. In turn, this makes it profitable for dealers to allocate capital against FHLBank underwriting and trading. Greater capital allocations, in turn, mean greater liquidity in the market.

This liquidity enables the FHLBanks to fund at attractive levels across a host of terms and structures. In turn, the FHLBanks pass this advantage on to their members. All members receive the benefit of attractive funding, regardless of their size. Because advances are made at relatively narrow spreads to borrowing costs, attractive issuance levels for FHLBank debt translates directly into lower advance rates for members. In turn, these members are able to pass these benefits on to their communities in the form of affordable credit.

Another benefit of the depth and liquidity of the market for FHLBank debt is that the FHLBanks are able to rapidly scale up their issuance with member demand for advances. The FHLBank debt franchise is well recognized and highly desired by a host of global investors due to its liquidity and credit quality. During 2008 and 2009, against a dislocated bond market, the

FHLBanks were able to increase debt outstanding by $365 billion over 14 months. This added funding provided a lifeline to financial institutions across the country. It is because of the depth and liquidity of the FHLBank debt market that the FHLBanks are able to tap the markets in size when demand surges—even during extreme distress.

Advances and Member Services

Members use advances to fund new originations and existing portfolios of mortgages, to purchase mortgage-backed securities, and to manage the substantial interest rate risk associated with holding mortgages in portfolio. Some members layer in term advances alongside their deposits, altering the duration profile of their liabilities to better suit their assets and mitigate risk. Other members use shorter-term, on-demand liquidity to offset unexpected deposit runoff or to take advantage of an opportunity to quickly add assets. By enabling members to effectively manage their balance sheets, advances lower the cost of extending credit to American consumers.

In accordance with statutory requirements, all advances are secured by eligible collateral and the purchase of capital stock. When FHLBanks issue advances, they lend against both the credit of the member-borrower and the quality of the collateral. Each FHLBank establishes its own processes and procedures for assessing the credit worthiness of borrowers and the appropriate lending value of pledged collateral. FHLBanks regularly monitor actual and potential borrowers' financial condition to ensure appropriate credit actions have been taken to protect the FHLBank against any potential loss arising from any extension of credit. In addition to evaluating members' financial reports, FHLBanks also monitor macroeconomic trends and local laws and regulations, and regularly interact with the member's management teams to ensure they stay attuned to the member's financial condition.

Each FHLBank establishes the types of assets that will be accepted as eligible collateral, defines the specific underwriting requirements and identifies the lendable value that will be applied to each eligible asset. Collateral practices vary among the FHLBanks with regional differences accounting for some of the differences. For example, some districts are dominated by larger commercial banks where others are primarily served by community lenders. Some markets display a concentration of loans exceeding the conforming loan limits, where others are well within the limits. On the coasts, there is a higher concentration of commercial real estate lending, and in the Midwest some institutions specialize in agricultural lending. Based on these regional differences and the risk appetite of each FHLBank, collateral practices will vary. Examples of these variations include, but are not limited to, the types of assets accepted as eligible collateral, the specific underwriting requirements applied to each asset class, the member's collateral reporting requirements, pricing techniques, and on-site collateral reviews.

The valuation and management of member collateral is a process that relies on regional expertise and market knowledge. During a time when many institutions attempted to streamline or outsource credit underwriting and collateral evaluation processes, the FHLBanks stuck to the basics and combined conservative collateral valuation practices with effective credit policies. The FHLBanks have an impressive track record as a result.

Beyond assessments and risk management, FHLBanks provide a variety of member services, such as correspondent services that leverage local knowledge to deliver value. While these services vary across the FHLBanks, it is clear that the strong relationships between FHLBanks and their members are mutually-beneficial and integral to the strength of each cooperative.

FHLBank Mortgage Programs

The FHLBanks have an excellent track record of working with members to manage risk in the mortgage purchase programs that some FHLBanks have administered for over 16 years. In these programs, a participating FHLBank purchases traditional conventional single-family mortgages originated by member institutions under a risk-sharing agreement between the FHLBank and the member. The FHLBanks essentially offer two different versions of mortgage purchase programs. The Mortgage Partnership Finance (MPF) Program generally involves the selling member providing a credit enhancement to the FHLBank that can be called upon if the performance of the pool of loans sold incurs losses above a certain level. The FHLBank of Chicago created the program and administers many aspects of the program for participating FHLBanks. Another MPF variation allows members to sell their loans through their FHLBank to Fannie Mae, although without any risk sharing obligation. The other program is the Mortgage Purchase Program offered by a few FHLBanks that essentially involves the creation of a reserve account against the pool of loans sold by the member that is paid out to the member over time depending on the loss experience of the pool.

The credit quality of mortgage loans funded by FHLBank members has proven to be excellent. The programs have experienced extremely low losses, particularly conventional loans funded through a program that uses a risk-sharing structure that ensures member lenders keep "skin-in-the-game". Of the $202.5 billion in conventional mortgages funded through either the MPF traditional program or the MPP program since their inception, only $303.6 million of losses have been realized, as of June 30, 2013, representing a loss ratio of only one fifteenth of one percent – 0.15 percent or 15 basis points. Only 1.78 percent of these loans were 90 days or more delinquent, or slightly more than half of the national average of 3.24 percent.

The very low level of credit losses (15 basis points) sustained by FHLBanks and their participating members since the beginning of these programs is truly remarkable considering it includes the period of time when the most severe economic stresses in the housing and credit markets in over 80 years were experienced.

These programs are an example of the success that can be achieved from "skin-in-the-game" mortgage partnerships. Community lenders exemplify "skin-in-the-game" business principles on a daily basis—their success is dependent upon being fully invested in the success and survival of the communities that they serve. Prudent underwriting, adequate appraisals, and the provision of appropriate credit products that suit an individual borrower's needs are fundamental operating principles for community lenders.

The FHLBank mortgage programs have been highly successful in adding value to members through product innovation and service. At a time when other secondary market participants are consolidating their services, increasing delivery and guarantee fees and imposing surcharges on low volume lenders (or providing high volume lenders with discounts), members have recognized that they can rely on their FHLBank to meet their secondary market needs. The mortgage purchase programs allow community financial institutions to be competitive with larger financial institutions and mortgage lenders and to remain active housing lenders within their communities.

Housing and Community Lending Programs

For more than 20 years, the FHLBanks' Affordable Housing Program (AHP) has been one of the largest private sources of grant funds for affordable housing in the United States. It is funded with 10 percent of the FHLBanks' net income each year. These grant funds are distributed through a competitive process to projects developed through partnerships of member institutions and local developers and housing organizations. AHP grants subsidize the cost of owner-occupied housing for individuals and families with incomes at or below 80 percent of the area median income (AMI), and rental housing in which at least 20 percent of the units are reserved for households with incomes at or below 50 percent of AMI. The subsidy may be in the form of a grant or a below-cost or subsidized interest rate on an advance. AHP funds are primarily available through a competitive application program at each of the FHLBanks. AHP funds are also awarded through a homeownership set-aside program to assist low and moderate income households in purchasing homes, with at least one-third of the funds being used to assist first-time homebuyers. The AHP allows for and encourages funds to be used in combination with other programs and funding sources, such as the Low-Income Housing Tax Credit. These projects serve a wide range of neighborhood needs: many are designed for seniors, the disabled, homeless families, first-time homeowners and others with limited resources. As of June 30, 2013 811,542 housing units have been built using AHP funds, including 490,572 units for very low-income residents. The total AHP dollars awarded from 1990 through June 30, 2013 is approximately $4.869 billion.

Each FHLBank also operates a Community Investment Program (CIP) that offers below-market-rate loans to members for long term financing for housing and economic development that benefits low- and moderate-income families and neighborhoods. Members use CIP advances to fund the purchase, construction, rehabilitation, refinancing, or predevelopment financing of owner-occupied and rental housing for households with incomes at or below 115 percent of AMI. The program is designed to be a catalyst for economic development since it supports projects that create and preserve jobs and helps build infrastructure to support growth. Lenders have used CIP to fund owner-occupied and rental housing, and to construct roads, bridges, and sewage treatment plants as well as to provide small business loans. From 1990 to 2012, the FHLBanks' CIPs have lent $68.040 billion for a variety of projects, resulting in 771,684 housing units.

The FHLBanks' Community Investment Cash Advance (CICA) programs offer funding, often at below-market interest rates and for long terms, for members to use to provide financing for projects that are targeted to certain economic development activities. These include commercial, industrial, manufacturing, and social services projects, infrastructure, and public facilities and services. CICA lending is targeted to specific beneficiaries, including small businesses, and households at specified income levels.

In addition to the competitive application program, AHP funds are also awarded through the homeownership set-aside program. Under this program, an FHLBank may set aside up to the greater of $4.5 million or 35 percent of its AHP funds each year to assist low- and moderate-income households purchase homes. Our members obtain the AHP set-aside funds and then use them as grants to eligible households.

Corporate Governance

Congress established a unique ownership and governance structure for the FHLBanks, which has served the FHLBanks well in the past and continues to do so today. A critical feature of this structure is that the FHLBanks are wholly owned by their members/customers so each FHLBank's interests are simultaneously aligned with those of its members and customers. In addition, the boards of directors of the FHLBanks are independent of management. No member of management may serve as a director of an FHLBank.

The Federal Home Loan Bank Act provides that a majority of each FHLBank's directors must be elected by its member financial institutions from among officers and directors of those institutions. Members vote for directors representing member institutions from their states. At least two-fifths of the directors must be independent (non-member) directors. The HERA Act of 2008 altered the governance structure of the FHLBanks to provide for the election of independent directors by the FHLBanks' members, rather than their appointment by the regulator. HERA also required that at least two of each FHLBank's independent directors must represent the "public interest" by having more than four years of experience in representing consumer or community interests on banking services, credit needs, housing, or financial consumer protection. The remaining independent directors must have demonstrated knowledge or experience in financial management, auditing and accounting, risk management practices, derivatives, project development, organizational management, or such other expertise as the FHFA Director provides by regulation.

The Federal Home Loan Bank Act also provides that no member may cast a number of votes in the election of directors greater than the average number of required shares held by members in its specific state. This prevents large members holding relatively large amounts of an FHLBank's capital stock from dominating director elections and, in practice, means that the majority of each FHLBank's member directors generally represent the small institutions that make up the great majority of members.

The statutory framework that controls the composition of the FHLBanks' boards of directors ensures that each FHLBank's board of directors will have a balance of interests represented. With no members of management on the board of directors, directors are in a position to independently oversee management actions. The members that contribute capital and benefit from the FHLBank's products and services are assured a majority of the directors. The director election voting preferences for small members ensure that larger members cannot dominate the board of directors and that an FHLBank's policies will not be detrimental to small members. Finally, the large contingent of independent directors ensures that the FHLBanks will benefit from perspectives and expertise independent of the membership.

Risk Management

The FHLBanks are highly regulated entities, subject to regulation and supervision by the Federal Housing Finance Agency (FHFA).

As 12 independent institutions, each FHLBank is responsible for appropriately developing and implementing its own risk management activities. The cooperative structure of the FHLBanks eliminates many of the incentives a publicly traded company might have to raise its risk profile, and in fact discourages FHLBanks from taking excessive risk. Just as FHLBank members do not expect equity investment returns on their capital stock investments in an FHLBank, they also do not expect equity investment risk in that investment. Members purchase FHLBank capital stock in order to obtain access to FHLBank funding products, and must maintain capital stock investments in the FHLBank as long as they continue to be members. Members provide the capital that supports their advance transactions with the FHLBanks. In this environment, members expect stability, reliability, and consistency of returns and credit product pricing. These member expectations are reflected in the oversight provided by each FHLBank's board of directors, a majority of which is comprised of directors representing member institutions.

Through a rigorous process, each FHLBank continually manages the pool of collateral backing an advance. This includes frequent monitoring of performance, pricing, and valuation. Members are required to maintain a sufficient pool of performing collateral, so they regularly replace delinquent loans and add collateral based on changes in haircuts and valuations. These precautions ensure sufficient overcollateralization at all times.

When an FHLBank lends to a troubled member, it does so in consultation with that member's primary regulator. In the event that the member subsequently becomes insolvent, this process enables the FDIC to minimize losses to the Deposit Insurance Fund. In a liquidation scenario, the FDIC typically pays off outstanding advances in exchange for the timely release of collateral in an attempt to maximize the resolution value of the institution. Should the FDIC opt out of this arrangement, the FHLBank can liquidate the collateral to pay off any advances.

For an FHLBank to take a loss on an advance the liquidation value of a member's pledged assets plus the member's investment in FHLBank stock would have to be less than the outstanding advance plus prepayment fees (the fair value of the advance). This is extremely unlikely— since the establishment of the FHLBanks in 1932, no FHLBank has taken a credit loss on an advance. In the event that collateral was insufficient to cover a defaulting member's borrowings, the next line of defense to FHLBank shareholders would be the failed member's investment in capital stock. This capital is proportional to either the size of the member (asset-based stock purchase requirement) or to the outstanding balance of advances (activity-based stock purchase requirement, which increases along with activity). It is hard to envision a situation in which a member would lose its capital investment in an FHLBank due to the failure of another member.

From the vantage point of debt investors and taxpayers, the FHLBanks' joint and several liability structure provides additional insulation from any loss that might occur at an individual FHLBank. Even if an FHLBank suffers losses, the aggregate amount of capital stock and retained earnings on the balance sheet of the 12 FHLBanks, collectively, would provide a deep layer of insulation from losses. The combination of the FHLBanks' cooperative structure and the multiple layers of risk mitigation provide an abundance of private capital to buffer bondholders and taxpayers from potential losses.

Financial Condition

The FHLBanks reported net income of $2.6 billion in 2012, up from $1.6 billion in 2011, making 2012 the most profitable year since 2007. For the third consecutive year, all 12 FHLBanks were profitable. As a result of this profitability, the FHLBanks have been able to continue building their retained earnings. As of year- end 2012 retained earnings were at $10.5 billion, having grown 250 percent since 2008 as the FHLBanks prudently strengthened this component of capital as a risk mitigant. Having completed their statutory obligation in 2011 under the Federal Home Loan Bank Act to make payments related to the Resolution Funding Corporation, all of the FHLBanks have entered into a Joint Capital Enhancement Agreement to further strengthen their financial soundness. Under this agreement, each FHLBank, on a quarterly basis, allocates 20 percent of its net income to a separate restricted retained earnings account established by that FHLBank. These restricted retained earnings accounts cannot be used to pay dividends to members and continue to build at each FHLBank until they are equal to one percent of that FHLBank's total outstanding consolidated obligations.

Attachment 2

FHLBank Member Views on Mortgage Markets – Survey Results

Member feedback

The FHLB Des Moines conducted an extensive survey with members during 2013 concerning their present and future need to be active providers of mortgage credit in the communities they serve. The information was gathered to gain a better understanding of members' current mortgage lending activity and to assess their needs in the evolving mortgage market environment to help determine the role FHLB Des Moines could potentially play in a new and modified housing finance system.

Below are key findings:

- Nearly all survey respondents view origination of residential mortgage loans as an important product offering in order to provide a very significant service to their customers. Customer retention, attracting retail deposits, providing all other services and income are the key reasons.
    - An overwhelming number of respondents offer long term, fixed rate mortgages due to customer demand, and most sell those loans to the secondary market rather than retaining them in portfolio.
    - A majority of respondents originate non-secondary qualified type residential mortgage loans and generally hold those loans in portfolio. Most loans held in portfolio are adjustable rate, balloon or shorter term fixed rate loans.
    - FHLB Des Moines advance products and MPF are critically important to members, assisting them to hold loans in portfolio or sell into the secondary market.
- Most respondents sell mortgage loans into the secondary market, including the MPF Programs. They do so primarily to mitigate interest rate risk but many also sell into the secondary market when net interest spreads are too low and/or to manage their volume and portfolio concentrations. Respondents feel that a secondary market is needed for small community banks in order to prevent large banks from completely dominating the markets, and many indicate FHLB Des Moines should be the provider/facilitator.
    - For many, MPF is one of their primary outlets for selling loans into the secondary market. Participation in MPF is a critical component of the member's business model.
    - Convenience, pricing and reliability are the top three reasons members participate in the MPF Programs. Trust and interest rate risk management are also factors.

  - Respondents that participate in the MPF Programs see the main benefits as the opportunity to offer long term, fixed rate loans at very competitive rates, increased profitability and the ability to retain customer relationships.

- A majority of respondents prefer to retain servicing, the primary reason being customer retention. However, due to competition, regulations and a lack of qualified staff, many end up selling the servicing.

  - A number of respondents noted they are evaluating retention of servicing rights due to the cost of the new servicer requirements.

  - When they sell servicing of their loans, they want to be able to sell to a trusted party who will provide excellent service to their customers, but who is not a competitor that might "steal" their customer relationships.

- Complexity and uncertainty surrounding new legislation and regulation brought on by Qualified Mortgage (QM) and Qualified Residential Mortgage (QRM) regulations are among respondent's largest concerns.

  - Approximately half do not see any change in their mortgage business due to new regulation while others anticipate a decrease in mortgage lending activity.

  - Some community lenders are leaving the mortgage business as compliance becomes more difficult and creates additional risk of losses.

  - Many respondents expressed concern that they will no longer be able to provide certain products that meet specialized customer needs due to QM and QRM.

Numerous respondents do not make mortgage loans but take applications and then send the application to another provider in exchange for a fee. Reasons include:

- Lack of a mortgage lending infrastructure

- Lack of capable, trained staff

- Lack of loan volume

- Concerns about regulatory/compliance issues and interest rate risk

PREPARED STATEMENT OF WILLIAM A. LOVING, JR.

PRESIDENT AND CHIEF EXECUTIVE OFFICER, PENDLETON COMMUNITY BANK, FRANKLIN, WEST VIRGINIA, AND CHAIRMAN, INDEPENDENT COMMUNITY BANKERS OF AMERICA

NOVEMBER 5, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, my name is William A. Loving, Jr., and I am president and CEO of Pendleton Community Bank, a $260 million asset bank in Franklin, West Virginia, that serves four rural markets in West Virginia and one Virginia community. I am also chairman of the Independent Community Bankers of America and I testify today on behalf of the nearly 7,000 community banks we represent. Thank you for convening this hearing on "Housing Finance Reform: Protecting Small Lender Access to the Secondary Mortgage Market".

We are grateful for your recognition of the critical importance of preserving community bank access in any reforms to the housing finance system. It is essential to borrowers and the broader economy that the details of any reform are done right. ICBA sincerely appreciates the opportunity to work with the Committee to craft housing finance reform legislation. We look forward to providing ongoing input on the impact of reform on community banks and their customers.

Community Banks and the Secondary Mortgage Market

Community banks represent approximately 20 percent of the mortgage market, and secondary market sales are a significant line of business for many community banks. According to a recent survey, nearly 30 percent of community bank respondents sell half or more of the mortgages they originate into the secondary market. [1] While many community banks choose to hold most of their mortgage loans in portfolio, robust secondary market access remains critical for them to support mortgage lending demand. This is particularly true for fixed-rate lending. For a community bank, it is prohibitively expensive to hedge the interest rate risk that comes with fixed-rate lending. Secondary market sales eliminate this risk.

Secondary market sales also play a critical role in helping community banks maintain their capital levels. While many community banks remain well-capitalized following the financial crisis, others are being forced by their regulators to raise new capital above minimum levels. The new Basel III rule will increase capital requirements. With the private capital markets still largely frozen for small and midsized banks, some are being forced to reduce their lending in order to raise their capital ratios. In this environment, the capital relief provided by selling mortgage loans in the secondary markets is especially important. Selling mortgage loans into the secondary market frees up capital for additional residential lending as well as other types of lending, such as commercial and small business, critical to supporting credit flow in small towns and communities.

Pendleton Community Bank holds most of its mortgage loans in portfolio. Our current portfolio includes nearly 1,500 loans valued at $76.6 million. However, in recent years we've sold an increasing volume of loans into the secondary market. In 2013, to date, we've sold 35 loans with a value of $4.5 million, which is already more in number and value than we sold all of last year, or in any prior year. We would sell more loans but are challenged, like many community bankers in small towns or rural areas, in identifying "comparable" sales in our rural markets where properties have unique characteristics which frequently disqualify them from secondary market sales.

Pendleton's secondary market sales are driven by customer demand for 30-year fixed-rate loans. As a community banker, meeting this customer demand is critical to our broader customer relationships and to our business model. As the housing market recovers, I expect we will continue to sell an increasing number of loans into the secondary market. Secondary market access is critical even for a primarily portfolio lender such as Pendleton.

Preserve What Works for Community Banks

The current GSE secondary mortgage market structure has worked well for community banks by providing equitable access, not competing at the retail level, and permitting community banks to retain mortgage servicing rights on the loans they sell.

Community banks selling directly to the GSEs today enjoy a very liquid market that permits them to effectively hedge interest rate risk and offer rate locks to their

[1] ICBA Mortgage Lending Survey. September 2012.

customers with relative ease and at a low cost. They access this market on a single loan basis, enjoy a virtually paperless loan delivery process, and generally receive funding from the GSEs in cash within 24 to 48 hours. Any new system of housing finance must be able to match the clear advantages of direct GSE sales enjoyed by community banks today.

Under the current GSE model, selling loans is relatively simple. Banks take out commitments to sell loans on a single-loan basis and are not required to obtain complex credit enhancements except for private mortgage insurance for loans in excess of 80-percent loan-to-value or other guarantees. Any future secondary market structure must preserve this relatively simple process for community banks and other small lenders that individually do not have the scale or resources to obtain and manage complex credit enhancements from multiple parties.

Potential Reforms

There is widespread agreement the secondary market must be reformed to prevent or greatly reduce the impact of devastating market failures that hobbled our economy. There is bipartisan consensus that, as the market recovers, the Government's dominant role in the housing market should be reduced to its more traditional role (less than 50 percent of secondary market sales). The private sector should return to its traditional role providing the majority of the capital in mortgage finance. ICBA welcomes the return to a more balanced and less concentrated housing finance system with an appropriate role for portfolio lenders, originate-and-sell lenders, and small as well as large lenders. If implemented thoughtfully, such a system would reduce the moral hazard and taxpayer liability of the current system.

In creating a new housing finance system to address the problems of the old system and restore balance among portfolio lenders, small financial institutions, and large lenders, policy makers must be careful not to create a new system that eradicates liquidity for all but the few largest players, limits access to the market or narrows options for smaller lenders, and imposes requirements that make it too costly for smaller lenders and servicers to participate.

Mutual

ICBA supports the creation of a Mutual Securitization Corporation (Mutual), as described in the Housing Finance Reform and Taxpayer Protection Act (S.1217), which would secure access to the secondary market for community banks and other small originators and would allow them to sell loans on a single loan basis, be paid in cash, and to retain the servicing rights. However, the success of the Mutual depends on the details and the implementation. The key considerations are: capitalization, technology, permitted activities, eligible sellers, and governance.

Capitalization

In order to provide equitable access, including the competitive pricing of the required third party credit enhancements and guarantees, the Mutual must be well-capitalized. While the exact level of capitalization will need to be determined by policy makers and the housing finance regulator, it is clear multiple sources of capital will be needed. If community banks and other small originators are required to provide the majority of the initial capitalization, the cost to the member institutions would be prohibitive. ICBA recommends using the profits of the current GSEs—or at least a portion of them—to capitalize the Mutual. The Mutual would be required to repay the Government over time through its operational earnings. An annual maintenance fee charged to all sellers to the Mutual, not to exceed $1,000, would also help to offset some of the operational costs of the Mutual.

Technology

In order to facilitate the transition to a new system, all loan aggregation infrastructure, including any automated underwriting, uniform appraisal delivery data portal, loan delivery systems, pooling and pricing, committing systems, cash transfer systems, loan activity reporting, and remittance systems should be transferred to the Mutual from the GSEs. Additionally, it will be necessary to transfer key GSE staff responsible for these functions along with the technology.

Eligible Sellers to the Mutual

The question of eligible sellers is critical to the viability and competitiveness of the Mutual and its ability to provide liquidity for all market participants. ICBA recommends all current approved GSE sellers and servicers in good standing with assets up to $500 billion be eligible to sell and service mortgages through the Mutual. In addition, the Federal Home Loan Banks and currently approved mortgage banking companies with an annual mortgage production of less than $100 billion should be eligible to sell to the Mutual. While the Mutual is targeted towards small to midsized lenders, larger institutions may prefer to sell loans for cash rather than securitize them. Allowing these larger lenders to access the Mutual will help build the scale needed to secure competitive terms for third party credit enhancements, improving liquidity for all sellers to the Mutual.

ICBA also believes the Mutual should be permitted to manage a limited retained portfolio comprised solely of eligible mortgage loans acquired from eligible sellers to the Mutual, to facilitate optimal pooling, credit enhancement, and securitization activities.

Governance and Regulation of the Mutual

To ensure proper representation of all the lenders who would use the Mutual to access the national secondary market, ICBA recommends a Board structure and the one member one vote voting structure similar to the FHLBs.

The Mutual, and the entire secondary market that uses any type of Government guaranty (apart from the FHLBanks, which would be regulated separately), should be regulated by an entity with powers and oversight duties similar to the FDIC. In addition to oversight of the Mortgage Insurance Fund, this regulator should set standards and review and approve all entities seeking to be issuers, guarantors, servicers, document custodians, credit enhancement providers, entities that intend to structure or restructure MBS or mortgage debt issued with a Government guarantee.

The housing finance regulator should have a governance structure similar to the FDIC. The CEO of the Mutual, at least one Mutual board member, and one FHLB member should have seats on the housing finance regulator board.

The Mutual should have a specific duty to serve all markets at all times, including small town and rural markets. This would include developing programs, underwriting guidelines, and appraisal rules to encourage the sale/securitization of loans on manufactured housing and housing in rural areas and small towns. ICBA would strongly support appraisal guidelines that would permit rural banks to sell more loans into the secondary market. The Mutual should be charged with developing both underwriting and appraisal guidelines that acknowledge the distinctive features of small town and rural markets, such as unique or large acreage collateral properties or borrowers who may have seasonal or farming income, and bar discrimination based on these features. Today it is difficult, if not impossible, to sell loans with such characteristics to the GSEs.

Role of the Federal Home Loan Banks

The Federal Home Loan Banks (FHLBanks) have several mortgage programs currently popular with community banks. Community bankers find the FHLBank mortgage programs recognize and compensate them for the high-credit-quality loans they originate. The FHLBank mortgage programs also permit the community bank to retain the servicing on mortgage loans sold, thereby maintaining the bank's relationships with their customers. Nearly 90 percent of ICBA members are FHLBank members.

The FHLBanks should be preserved as an access point to the national secondary market for community banks and should be eligible to sell loans to the Mutual. The additional option of selling to the FHLBanks, an arrangement with which many community banks are comfortable, is fully consistent with the role of a Mutual, would provide two access points, and would ease the transition to a new system.

ICBA is concerned about proposals that would rely on the FHLBanks as the sole aggregators for community banks. Community banks need more secondary market options, not fewer. However, secondary market activities do pose new risks for the FHLBanks. In the past, some FHLBanks that concentrated more heavily on their mortgage programs experienced serious financial problems. Though ICBA supports the FHLBanks role in the secondary market, the regulator must be vigilant that FHLBank secondary market business not be a distraction from the primary function of the FHLBanks: providing liquidity and wholesale funding through the advance business. Community banks depend on FHLBank advances, and secondary market reform should not put this important source of liquidity at risk.

Regulatory oversight of the FHLBs should remain separate with an independent agency as currently structured.

Underwriting and Servicing

Only loans meeting the Qualified Mortgage (QM) definition, as defined by the Consumer Financial Protection Bureau (CFPB), should be eligible for securitization and/or sale through the Mutual and contain a Government guaranty. ICBA does not believe additional underwriting criteria should be set in statute. Rather, underwriting standards should be set and administered by the housing finance regulator for loans and securities seeking a Government guarantee.

Servicing standards should be consistent with current GSE servicing standards, and should accommodate any exemptions small servicers enjoy under the CFPB mortgage servicing rules.

Transition From GSEs to the New Guarantor Structure and Mutual

The transition from the current GSEs to the new credit enhancement/guarantor structure must be gradual and transparent to prevent the disruption of the flow of funds into the housing market. This will allow the marketplace the opportunity to properly evaluate the value of the new credit enhancement/guarantor structures along with any changes in the pass-through structures of the mortgage-backed securities issued. In particular, the plan must address the need to maintain liquidity and investor acceptance of the new mortgage-backed securities.

This could be accomplished by preserving the GSEs as a backstop during the construction and transition to the new securitization platform. Newly issued GSE securities could be conformed to credit enhancement structures similar to the proposed structures to allow the market to adapt to the change. Selected functions and technologies of the GSEs—such as the GSEs' cash window pooling, credit enhancement, securitization processes—could be moved to the Mutual, while more market-critical functions, such as the cash window, remain at the GSEs. The new guarantor structure (the FMIC guaranty, in the case of S.1217) could then be substituted for the GSE guaranty, followed by a period during which the regulator monitors market reaction and acceptance. Once the regulator determines the market has accepted the FMIC guaranty, it could be made available to all approved issuers, and finally, the last GSE backstop, the cash window aggregation activities, could be moved to the Mutual and the GSEs could be shut down. Other methods could be equally effective in avoiding market disruption, but it is critical that the transition be carried out with transparency and deliberation.

S.1217

ICBA is grateful to Senators Warner, Corker, and all the Committee cosponsors for introducing S.1217, the Housing Finance Reform and Taxpayer Protection Act. ICBA sincerely appreciates the opportunity to provide input into this bill. We are encouraged by the inclusion of certain provisions to address ICBA's concerns. In particular:

- The Mutual Securitization company would secure access to the secondary market for community banks and other small originators and would allow them to sell loans for cash and to retain servicing rights.
- The Federal Home Loans Banks would also be allowed to issue securities, creating another access point for community banks.
- Limiting issuers to no more than 15 percent of outstanding guaranteed securities would reduce concentration in the securitization market by large banks or Wall Street firms.
- The FMIC guarantee, well-insulated by private capital, would insure the securitization market continues to function in times of market stress.

These provisions would help provide access for community banks to the secondary market without requiring them to take on the additional risk and cost of securitizing loans.

ICBA continues to evaluate and make recommendations for improving S.1217, so that it better addresses the concerns identified in this testimony. As noted above, we recommend significantly broadening access to the Mutual so that lenders with up to $500 billion in assets are eligible to sell loans.

Another major concern is that the proposed system is significantly complex relative to the current system. Credit enhancements require significant scale as well as legal, compliance, and technological resources. In addition, the management of multiple counterparties can create additional risks for both the marketplace and the issuers themselves. Because these risks would be too great for small lenders to bear, requirements for complex credit enhancements as part of a secondary market housing finance system would force additional market consolidation and shift yet more control to the largest lenders and Wall Street firms. Community banks must be accommodated with a simple, direct method of selling loans.

Closing

Mortgage lending is very important to community banks as they serve their customers. They make high-quality loans in their local communities funded by local deposits. However, they cannot, in all circumstances, hold 100 percent of the mortgages they originate in portfolio. Customer demand for long-term fixed-rate mortgages and the imperative of reserving their balance sheets to serve the other credit needs of their communities require all community banks have robust secondary market access. Equal and straightforward access to the secondary market is a critical component for community banks. It is very important efforts to restructure the housing finance system continue to provide this essential portal to small financial institutions.

ICBA is pleased to see a robust debate emerging on housing finance reform. We look forward to continuing to work with Members of this Committee to create a system in which community banks and lenders of all sizes are equally represented and communities and customers of all varieties are served.

PREPARED STATEMENT OF BILL HAMPEL

SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, CREDIT UNION NATIONAL ASSOCIATION

NOVEMBER 5, 2013

Chairman Johnson, Ranking Member Crapo, Members of the Committee: Thank you very much for the opportunity to testify at today's hearing. My name is Bill Hampel, and I am senior vice president and chief economist at the Credit Union National Association (CUNA). CUNA is the largest credit union advocacy organization in the United States, representing America's State and federally chartered credit unions and their 97 million members. I am very pleased to present the credit union system's view on housing finance reform proposals before the Committee.

The system of housing finance, as it existed up until 2007, was one of many causes of the financial shock and deep recession of the last decade. With the two major Government-sponsored enterprises (GSEs) in conservatorship and the private secondary market still moribund, major overhaul of the system is required. The design flaws of the old system must be addressed. New rules will be required. Congress must get reform legislation right or risk further damage to an already fragile economy.

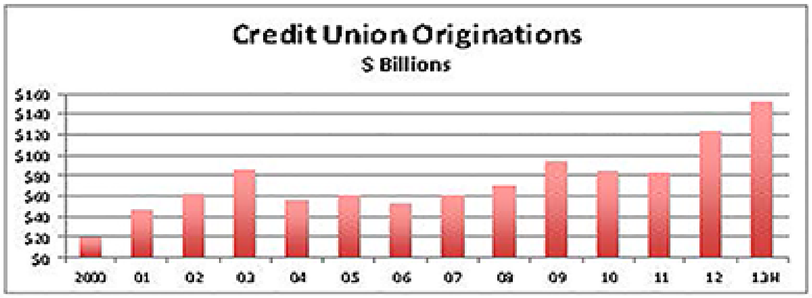
This testimony will focus on the key components of housing finance reform legislation from the perspective of the credit union system, using S.1217, the Housing Finance Reform and Taxpayer Protection Act, as base from which to react and recommend changes.

Overview of Credit Union Mortgage Lending

As member-owned, not-for-profit financial cooperatives, credit unions strive to meet their members' financial services needs, and offering home mortgages is an important part of meeting member demand. Some credit unions have made first mortgage loans since their inception, but most did not offer mortgage lending services until the 1970s. Credit unions now serve more than 97 million Americans, and first mortgage lending is an increasingly important component of credit union lending. First mortgages now account for 41 percent of the total loans held in portfolio, with the remaining 59 percent of a credit unions portfolio comprised of second mortgages (12 percent), consumer loans (41 percent) and small business loans (7 percent). Just last year alone, credit unions originated $123 billion of first mortgages, representing 6.5 percent of the entire mortgage origination market. Credit unions are now significant players in residential real estate finance, and historically our market share has risen annually to reflect the growing demand of our members.

Currently, 4,295 credit unions (63 percent) offer first mortgages to their members. Because larger credit unions are more likely to offer mortgages than smaller ones, 93 million (96 percent) of all credit union members belong to a credit union that offers first mortgages. It is clear that consumers are choosing credit unions more and more to be their mortgage lenders, and as Congress considers housing finance reform, it is critical that credit unions have equitable and readily available access to a functioning, well-regulated secondary market and a system that will accommodate the member demand for long-term fixed-rate mortgage products in order to ensure they can continue meeting their members' mortgage needs.

From 2000 to 2006, annual credit union originations of first mortgages averaged just under $55 billion. As the subprime mortgage crisis began to weaken the secondary market for mortgage loans in 2006 and 2007, credit union origination volume rose dramatically. Homebuyers increasingly turned to their credit unions as other sources of mortgage lending dried up. Credit unions were able to meet this demand because at the time they primarily funded loans from their own portfolios, and their conservative financial management as cooperatives meant they were less affected by the financial crisis than many other lenders. By 2009, credit union originations rose to $94 billion. New loan volume fell to just above $80 billion in 2010 and 2011 before rising to $123 billion in 2012 and $132 billion the first half of 2013, at an annual rate. This recent increase in volume is due to the desire on the part of many members to refinance their loans given very low interest rates.



Total first mortgage originations from all lenders peaked at $3.1 trillion in 2005 before plunging to only $1.5 trillion in 2008. Since then, originations have recovered to just over $1.8 trillion in 2012, at an annual rate of $2 trillion in the first half of 2013. Because credit union lending increased while the broader market was wracked by the financial crisis, the credit union share of mortgage lending sharply increased, from less than 2 percent in 2005 to almost 6 percent in 2008. Since then, as the broader mortgage market recovered, credit union lending continued to grow to the point that it accounted for over 6 percent of the market in 2012 and 2013.

Historically, credit unions have been largely portfolio lenders. From 2000 to 2008, credit unions sold only a third of first mortgage originations, ranging from a low of 26 percent in 2007 to a high of 43 percent in 2003. The decision of whether to hold or sell a loan depends primarily on asset-liability-management issues, essentially the need to manage interest rate risk, but also at times, depends on the availability of liquidity in the credit union. Asset liability management hinges on such factors as the level of interest rates, the relative demand for fixed versus adjustable loans from members, the amount of fixed-rate loans and other longer-term assets already on a credit union's books and the maturity of the credit unions funding sources. Managing credit risk is not the primary factor in secondary market decisions by credit unions. However, even for those loans intended to be held in portfolio, credit union prudential regulators strongly encourage writing all first mortgages to conformed standards for potential sale.

As long-term interest rates plunged in 2009 and again in 2011, credit unions found it increasingly important to sell longer-term, fixed-rate mortgages to avoid locking in very low earning assets for the long term. As a result, the proportion of loans sold almost doubled, to an average of 52 percent from 2009 to the present.

Servicing member loans is very important to credit unions, for a number of reasons. As member-owned cooperatives, credit unions are driven by a desire to provide high quality member service. Many credit unions are reluctant to entrust the core function of serving members to others, unless they have a stake and a say in the entity doing the servicing. Credit unions are also concerned that third-party servicers might use the data they gather about credit union members to market competing products or services. In addition, credit unions benefit from the steady servicing income stream. As such, many credit unions service both the substantial portfolios of loans they hold on their own balance sheets, and the loans they have sold to the secondary market. Currently, in addition to the $258 billion of first mortgages that credit unions hold in portfolio, they also service $151 billion of loans they have sold.

The credit quality of credit union first mortgages held up remarkably well during the recent financial crisis, especially when compared to the experience of other lenders. Other lenders experienced net charge-off rates four times higher than those at credit unions. Prior to the Great Recession, annual net charge-off rates on residential mortgage loans at both banks and credit unions were negligible, less than 0.1 percent. However, as the recession took hold, losses mounted. At credit unions, the highest annual loss rate on residential mortgages was 0.4 percent. At commercial banks, the similarly calculated loss rate exceeded 1 percent of loans for 3 years, reaching as high as 1.58 percent in 2009.

There are two reasons for this remarkable record at credit unions. First, as cooperatives, credit unions tend to be more risk-averse than stock-owned institutions. The incentives faced by credit union management (generally uncompensated volunteer boards, the absence of stock options for senior management and board members, the absence of pressure from stockholders to maximize profits) discourage management from adopting high-risk, higher-return strategies in pursuit of high profits. As a result, credit union operations are more consumer-friendly, less risky and subject to less volatility over the business cycle. This largely explains why credit unions were able to increase lending as the financial crisis deepened.

Second, since the bulk of credit union lending is intended to be held in portfolio rather than sold to investors, credit unions tend to pay particular attention to such factors as a member's ability to repay a loan, proper documentation and due diligence and collateral value before granting loans.

We believe that in addition to ensuring access to the secondary market for credit unions, it is also important that the housing finance system Congress puts in place accommodates the demand of credit union members and other consumers for long term, fixed-rate mortgage products. The data suggest that credit union members overwhelmingly prefer fixed-rate mortgages. Over the past 10 years, our members have chosen a fixed-rate mortgage over 80 percent of the time. Just in the first half of 2013, 83 percent of the mortgages issued by credit unions were at fixed rates. Congress should acknowledge that the American homebuyer prefers fixed-rate mortgages and do everything in its power to ensure this important mortgage product remains a valuable part of housing finance.

Credit Union Principles for Housing Finance Reform

As we have testified in the past, CUNA supports the creation of an efficient, effective, and fair secondary market with equal access for lenders of all sizes. To this end, CUNA supports housing finance reform proposals that are consistent with the following principles, and have been subject to full and fair consideration with respect to potential impact on all market participants:

Neutral Third Party

There must be a neutral third party in the secondary market, with its sole role as a conduit to the secondary market. This entity would necessarily be independent of any firm that has any other role or business relationship in the mortgage origination and securitization process.

Equal Access

The secondary market must be open to lenders of all sizes on an equitable basis. CUNA understands that the users (lenders, borrowers, etc.) of a secondary market will be required to pay for the use of such market through, for example, fees, appropriate risk premiums and other means. However, guarantee fees or other fees/premiums should not have any relationship to lender volume.

Strong Oversight and Supervision

The entities providing secondary market services must be subject to appropriate regulatory and supervisory oversight to ensure safety and soundness, for example by ensuring accountability, effective corporate governance and preventing future fraud; they should also be subjected to strong capital requirements and have flexibility to operate well and develop new programs in response to marketplace demands.

Durability

The new system must ensure mortgage loans will continue to be made to qualified borrowers even in troubled economic times. Without the backstop of an explicit federally insured or guaranteed component of the revised system, CUNA is concerned that private capital could quickly dry up during difficult economic times, effectively halting mortgage lending altogether.

Financial Education

The new housing finance system should emphasize consumer education and counseling as a means to ensure that borrowers receive appropriate mortgage loans.

Predictable and Affordable Payments

The new system must include consumer access to products that provide for predictable, affordable mortgage payments to qualified borrowers. Traditionally this has been provided through fixed-rate mortgages (such as the 30-year fixed-rate mortgage), and it is important that qualified borrowers continue to have access to products that provide for predictable and affordable mortgage payments.

Loan Limits

The new housing finance system should apply a reasonable conforming loan limit that adequately takes into consideration local real estate costs in higher cost areas.

Affordable Housing

The important role of Government support for affordable housing (defined as housing for lower income borrowers but not necessarily high risk borrowers, historically provided through FHA programs) should be a function separate from the responsibilities of the secondary market entities. The requirements for a program to stimulate the supply of credit to lower income borrowers are not the same as those for the more general mortgage market. We believe that a connection between these two goals could be accomplished by either appropriately pricing guarantee fees to minimize the chance of taxpayer expense, and/or adding a small supplement to guarantee fees, the proceeds of which could be used by some other Federal agency in a more targeted fashion in furtherance of affordable housing goals.

Mortgage Servicing

Credit unions should continue to be afforded the opportunity to provide mortgage servicing services to their members in a cost-effective and member-service oriented manner, in order to ensure a completely integrated mortgage experience for credit union members/borrowers. To lose this servicing relationship would be detrimental not only to a vast majority of credit union members/borrowers, but could also result in fewer mortgage choices available to credit unions and their members, with higher interest rates and fees being imposed on both. If national mortgage servicing standards are developed, such servicing standards should be applied uniformly and not result in the imposition of any additional or new regulatory burdens upon credit unions.

Reasonable and Orderly Transition

The transition from the current system to any new housing finance system must be reasonable and orderly.

S.1217

S.1217 would wind down Fannie Mae and Freddie Mac, and replace the Federal Housing Finance Agency with a new entity, the Federal Mortgage Insurance Corporation (FMIC). FMIC would provide insurance on certain mortgage-backed securities (MBS); this insurance would convey a full-faith-and-credit of the Federal Government guarantee. FMIC would also regulate the secondary mortgage market. The legislation would also cause the creation of a mutual securitization company designed to assist small lender access to the secondary mortgage market.

CUNA believes the general approach to housing finance reform embodied in S.1217 to be very well thought out and sound public policy. S.1217 corrects the fatal design flaws of the previous system, while maintaining the effective aspects of that system to create a structure designed to serve borrowers and lenders of all sizes well, preserving a backup Government guarantee with sufficient protections that risk to the taxpayer is reduced to nearly zero. However, we do have some suggested improvements to the law that will be necessary for it to work for small lenders, and we hope the Committee will take these suggestions into consideration when crafting a new bill. Before discussing those modifications, two general points should be covered: the danger of wringing too much risk out of the system, and the interplay of mortgage lending regulation from two sources, the Consumer Financial Protection Bureau (CFPB) and the FMIC.

There are two types of potential errors in designing a robust housing finance regime. A Type 1 error would allow excessive risk-taking, making a repeat of the crisis of the last decade likely. A Type 2 error would eliminate too much risk, making housing finance more expensive and cumbersome than it needs to be, and unnecessarily excluding too many borrowers from the market. Finding the happy medium that balances off both errors is of course very difficult. With the recent crisis still fresh in the memory, there is likely to be an understandable but unfortunate tendency to minimize Type 1 errors, at the expense of more Type 2 errors. The specific rules, parameters, prescribed underwriting criteria, etc., currently considered appropriate are likely to be more risk-averse than those necessary for a healthy, robust housing finance system in the long run. Therefore, a reformed system should have sufficient flexibility to be able to adjust and fine-tune the rules, norms and procedures as experience is gained. However, care must be taken not to set in motion a process whereby additional risks are incrementally added to the point that the system collapses. This is particularly important given the moral hazard that comes with any form of Government guarantee. Balancing these pressures can best be accomplished by not laying down immutable rules, but rather by establishing institutions that will not be driven by their incentive structures to exploit the moral hazard of a Government guarantee, and by empowering an independent regulatory structure with the dual mission of taxpayer protection and efficient market operation.

The Senate's development of housing finance reform legislation will, among other things, establish a new and revised regulatory structure for the mortgage market. This is necessitated by the failure of the previous regulatory structure. However, this is not the first time Congress has addressed the regulation of mortgage lending since the financial crisis. Much of the Dodd-Frank Act requires a plethora of new consumer protections in mortgage lending, currently being implemented by the CFPB. Much, although not all, of the rulemaking of the proposed FMIC will overlap with rules already promulgated by the CFPB. For example, there are the underwriting standards for a loan to be eligible to be included in a covered security, and those necessary for consumers to be protected on an "ability to repay" standard. It is quite possible that the details of those two sets of guidelines should not be exactly the same. Rather than simply defaulting to the proposed CFPB standards, the Senate may wish to establish procedures for the CFPB and the FMIC to coordinate on the future evolution of shared rules to take account both of consumer protection and effective mortgage market operation.

Small Lender Access to the Secondary Market

The secondary market must be open to lenders of all sizes on an equitable basis. Credit unions need to know that as long as they produce one or more eligible mortgages, they will be able to sell them to an issuer of Government-backed securities, directly or through an aggregator, at market prices, for cash, without low-volume penalties, and with the option to retain servicing on the loans. In addition, standardization of all steps of the process is very important to credit unions.

Some form of issuer should be established so that small lenders, including credit unions, will have unfettered access to the secondary market. This entity should be independent of any firm that has any other role or business relationship in the mortgage origination and securitization process. S.1217 envisions a mutual securitization company, regulated by the Government guarantor; we believe this would be an appropriate vehicle to perform that function, provided certain changes were made with respect to membership, governance, capital, and powers.

S.1217 would cap membership in the mutual to institutions with less than $15 billion in assets. We believe that this cap is far too low, and would suggest that lenders of almost any size should be able to use the mutual, so long as they do not themselves issue covered securities. Restricting the mutual to serving just smaller lenders would preclude achieving necessary scale economies. Indeed, it would be desirable for the mutual to be among the largest if not the largest issuer of covered securities.

The mutual should have access to the common securitization platform being developed under the auspices of the FHFA, and any other relevant infrastructure of the GSEs as they are wound down. Much of that infrastructure, including personnel and technology, works very well, and it would be very inefficient to remove and replace it completely rather than to transfer it to the new mutual.

The governance structure is also important to the long-term success of the mutual. We believe the best model would be as a cooperative, with a board elected to represent all classes of membership, allocated by type and size of lender, perhaps with regional diversification too. Board elections should be on a one-member, one-vote basis within classes. The bylaws of the mutual should stipulate operating principles and requirements, such as providing access to all qualifying lenders, regardless of size. Although the operating practices and procedures of the mutual should be allowed to evolve over time based on management action and board approval, changes to the basic mission of the mutual, to provide unfettered access to the secondary market for lenders of all sizes, which should be expressed in the bylaws, should not be subject to change in the future.

The mutual will need to have sufficient capital to support a small balance sheet—enough to hold mortgages from multiple originators before they can be packaged into securities, and perhaps to hold some mortgages in the process of modification. While it may be necessary for mutual members to put up a small amount of capital, the operation of the mutual securitization company should be funded primarily by per-transaction fees.

The mutual should be permitted to issue both covered and private label securities (PLS), with clear disclosure to investors. This will provide small lenders with an outlet for nonqualified mortgage (QM) loans. It could also in the long-term reduce the Government's exposure to the housing finance system by facilitating the provision of purely private capital. It could also help ensure the availability of credit to otherwise creditworthy borrowers who may just fall short of meeting the requirements of a qualified mortgage. To facilitate the issuance of PLS, all of the standardized processes applied to the creation of covered securities should also be available for private label securities. In addition, bond guarantors should be allowed to provide some coverage for PLS, so long as reserve funds for covered and private securities are not comingled.

In addition to establishing a mutual securitization company tasked with ensuring access to the secondary market for small lenders, Federal Home Loan Banks (FHLBs) should also be eligible to operate as approved issuers so long as they meet all relevant requirements. This would provide an option for small lenders. However, the eligibility of FHLBs to serve as issuers does not reduce the need for a mutual securitization company.

Government Guarantee

The new system must include consumer access to products that provide for predictable, affordable mortgage payments to qualified borrowers. Traditionally this has been provided through fixed-rate mortgages (such as the 30-year fixed-rate mortgage), and it is important that qualified borrowers continue to have access to products that provide for predictable and affordable mortgage payments.

In order to facilitate the continued availability of affordable, long-term, fixed-rate mortgages for American homeowners, some form of ultimate Government guarantee should be available for qualifying mortgage-backed securities. However, the taxpayer must be protected from the unnecessary exercise of this guarantee by appropriate standards in mortgage lending, and by layers of sufficient private capital for loss absorption. The Government guarantee should be the last, not the first line of defense. We are pleased that S.1217 includes an explicit guarantee.

In addition to an 80-percent maximum loan-to-value for each mortgage in a covered security (provided by downpayment, private mortgage insurance, or a combination of the two), sufficient private capital should be available to absorb the first loss on any mortgage in a covered security. In theory, this could be accomplished either by a bond guarantee, a senior-subordinated deal structure or some other capital market structure. However, in practice, we believe that the bond guarantor approach would be preferable. During periods of stable financial markets, a healthy macro economy and strong housing markets, senior-subordinated deal structures are likely to underprice long-term risk compared to bond guarantors. During periods of stress, such as the recent Great Recession, senior-subordinated deals are unlikely to be available at any price, but bond guarantor coverage would likely be available, although at a premium price. In addition, a security structure system would likely favor larger over smaller originators and issuers because investors would prefer to limit due diligence to a small number of large institutions.

Another potential advantage of a bond guarantor approach would be the ability of the FMIC to step in for private bond guarantors in exigent times, to serve as a countercyclical backstop for the housing market, rather than simply suspending the requirement for first loss coverage for arbitrary periods when markets are troubled. If private bond guarantees were temporarily unavailable, or extremely expensive, FMIC could sell this coverage to issuers of eligible securities at a price determined by formula (for example 125 percent or 150 percent of the average cost of such coverage over the preceding 2 to 5 years). Once market conditions stabilize, the contract could be sold to a private bond guarantor. In other words, in stressed markets, rather than temporarily waiving the requirement for first loss coverage, the Government should provide, and charge for, such coverage.

The amount of private capital necessary to protect the taxpayer is of course important. Too little capital places the taxpayer at risk. Too great a capital requirement unnecessarily raises the cost of mortgages to borrowers. The appropriate amount depends on: the amount of capital held by the ultimate Government guarantee fund (FMIC), the amount of loss on any security that the private capital will be responsible for (the attachment point), the maximum loan-to-value of mortgages in covered securities and required underwriting standards for eligible mortgages. Assuming an attachment point of 10 percent, the amount of private capital necessary to cover a maximum 10-percent loss on any covered security will be substantially less than the amount necessary to cover a maximum 10 percent on all covered securities.[1] So long as eligible mortgages must have maximum loan-to-value ratios of 80 percent, or private loan-level mortgage insurance and must comply with the Qualified Mortgage (QM) rule, the likelihood that all covered mortgage-backed securities would simultaneously suffer losses of at least 10 percent during anything

[1] Whether a bond guarantor's 10-percent first-loss exposure would apply to just each guaranteed security, or to groups (e.g., a vintage of securities) would have an effect on the amount of capital required. We believe the exposure should be limited to single securities or short vintage windows, for example, for all securities guaranteed during a quarter rather than a year.

short of a total economic and financial collapse (such as the Great Depression of the 1930s) is negligible. Further, the required amount of capital or reserve funds should depend on the seasoning of the securities on which a bond guarantor provides first loss coverage. Older securities should require lower (not zero) reserve funds.

For all the reasons just listed, substantially less than 10 percent of the total exposure of private bond guarantors would be necessary to provide the 10-percent first-loss coverage. Legislation should require the 10-percent first-loss coverage, but leave it to the FMIC to determine the amount of private capital or reserve funds necessary to provide that 10-percent first-loss coverage under conditions no less severe than the recent Great Recession.

In the event of the failure of a mortgage in a covered security, the FMIC should ensure timely payment of principle and interest to investors in covered securities, and immediately demand payment from the bond guarantor. The fact that investors could look to the FMIC rather than a collection of private bond guarantors for payment would contribute to the homogeneity of covered securities, increasing the liquidity of the securities. Payment from the bond guarantor to FMIC would be required so long as total losses on a security (or a defined group of securities, such as a vintage) had reached 10 percent of the value of the security. In the event total losses on mortgages in a security or group exceed 10 percent of the value of the security or group, the Government backup fund should cover losses in excess of 10 percent.

It is likely that under this arrangement there could actually be instances when the Government backup fund covered losses on covered securities without the bond guarantor itself having to fail, i.e., if one or more but not all of the securities covered by a private bond guarantor experienced losses of greater than 10 percent, but the guarantor's capital was not depleted. Indeed, a properly reserved bond guarantee fund should be able to cover losses up to 10 percent of the balance of covered securities and still remain in business. In other words, the payment of losses by FMIC after the 10-percent first-loss coverage should not require a catastrophic event, i.e., the exhaustion of a pool of private capital.

A 10-percent attachment point would likely make recourse to the Government backup fund extremely rare, but not unheard of. A reformed housing finance system that envisages no payments out of the privately funded reserve balance of the Government guarantor would be erring on the side of being too conservative. The goal should be absolute protection of taxpayers, and that should allow the FMIC to occasionally operate as a shock absorber, using funds it has collected from market participants. This would be similar to the way the NCUSIF and the FDIC pay depositors in failed federally insured credit unions and banks, not with taxpayer funds, but with reserves paid for by insured institutions.

The Government should be prohibited from assisting private bond guarantors. Instead, the Government should be prepared to quickly pay all legitimate claims not covered by a private bond guarantor, and to resolve the bond guarantor if the Government is not reimbursed for such claims in a timely fashion. The Government should also be prepared to temporarily sell first loss coverage to issuers in times of market stress, as described elsewhere in this testimony.

The entity that provides the Government guarantee should also have the regulatory responsibility, as envisioned by S.1217. Since the entity that provides the Government guarantee will be responsible for protecting the taxpayer from losses resulting from that guarantee, that entity must have the authority to establish regulations to ensure that all of the many players in the complex housing finance system act in a fashion that does not expose the taxpayer to any losses.

Underwriting Standards

Ultimately, the underwriting standards for a loan to qualify for inclusion in a covered security should be controlled by the Government agency responsible for covering losses on such securities: the FMIC. A similar system has worked fairly well for the FDIC and NCUSIF in establishing prudential standards for bank and credit union operation. Therefore, the less explicitly underwriting standards are prescribed in legislation, the better. Whereas QM standards could serve as a starting point for FMIC established standards, the law should not explicitly require that only QM loans could be eligible mortgages. The ability of a borrower to repay a loan depends on a number of characteristics; not just the absolute level of each characteristic, but also the interplay among those characteristics. Many of the underwriting standards of the QM rule are entirely appropriate for an eligible mortgage: documentation requirements, payment and debt ratio calculation methods, etc. But a bright line ceiling of 43 percent on the debt-to-income ratio, without any ability to consider other factors, would exclude too many qualified borrowers from enjoying the benefits of FMIC covered mortgages. For example, consider a borrower applying for an adjustable rate mortgage with annual adjustments after 1 year, a low downpayment and a barely prime credit score. For such a borrower, even a 43-percent debt ratio could be far too high. However, for another borrower applying for a 30-year fixed-rate loan with a large downpayment, an active and pristine credit record and other positive characteristics, a 50-percent debt ratio could be completely acceptable.

FMIC should be instructed by Congress to create standards that facilitate consumer access to mortgage credit consistent with the overriding goal of minimizing risk to the taxpayer of paying for losses on covered securities, recognizing that those standards should evolve through time. Those standards may be similar to QM standards, but should not be required to be the same as QM standards.

Regulatory Structure

The entities providing secondary market services must be subject to appropriate regulatory and supervisory oversight to ensure safety and soundness, for example by ensuring accountability, effective corporate governance and preventing future fraud; they should also be subjected to strong capital requirements and have flexibility to operate well and develop new programs in response to marketplace demands.

The regulator created through any reform of the housing finance system must have a role centered on supporting securitization that does not duplicate the role of other regulators in the process. Both issuers and servicers are heavily regulated by a myriad of Federal agencies, including the Bureau of Consumer Financial Protection (CFPB), Department of Housing and Urban Development and Department of Agriculture, in addition to the supervision performed by prudential regulators. Credit unions and other small lenders are drowning in regulation in the mortgage area, and we fear curtailing products and services as a result. Credit union members, and our housing recovery, lose as a result of regulatory burden. It is essential that any housing finance reform not create additional regulatory burden at the originator or servicer level; in fact, if done properly, the implementation of a new housing finance system could provide an opportunity to reduce credit unions' and other small lenders' regulatory burden, as we discuss later in this testimony.

That said, the secondary market needs strong regulatory oversight to ensure equal access for small institutions and an orderly functioning of the system. At a high level, the regulator should be a neutral third party that would ensure the secondary market is open to lenders of all sizes on an equitable basis, with equal pricing regardless of lender volume. Ideally, the regulator would provide issuers who feel they are not receiving equal treatment in the secondary market with an administrative process to protest. In turn, the regulator should have substantial authority to order a remedy, including banning the secondary market participant from using FMIC.

We envision a regulator in the mold of the National Credit Union Administration (NCUA) or the Federal Deposit Insurance Corporation (FDIC), with direct examination and supervisory authority, given that the full faith and credit of the United States stands behind FMIC insurance, as it does with NCUA or FDIC insurance. The entities providing secondary market services must be subject to appropriate supervisory oversight to ensure safety and soundness, for example by ensuring accountability, effective corporate governance and preventing future fraud; they should also be subjected to strong capital requirements and have flexibility to operate well and develop new programs in response to marketplace demands. In terms of specific powers, at a minimum, the regulator should have the authority to make rules, examine and supervise secondary market participants, suspend or revoke the power of any secondary market participant to use FMIC, place any secondary market participant into conservatorship or involuntary liquidation and study the operation of the secondary mortgage market to determine if its regulations are leading to the most efficient operation.

In terms of the regulator's governance structure, we recommend a board appointed by the President with the advice and consent of the Senate that would serve for fixed terms of 5 or more years (so as to be longer than the term of any one President). It is important for credit unions that, by statute, the board be required to include credit union representation. The board members should have minimum qualifications set by statute and come from the private marketplace, not be representatives of another regulatory agency. We leave it to Congress to set the minimum criteria for service on the board, but note that a minimum of 10 years of mortgage lending experience should provide the operational knowledge necessary to understand issuer concerns. Staggering terms of service makes sense to ensure continuity of the board.

The regulator could be funded by a small portion of the guarantee fee. We believe the regulator should have an Office of Small Lender Access and Equality, dedicated to the concerns of credit unions and banks under $15 billion in assets. That office should have the authority to study the pricing small institutions receive in the secondary market to determine if small institutions receive fair pricing.

In terms of the regulatory issues surrounding "too big to fail" and the housing regulator's interaction with other regulators, the new housing regulator should have a seat on Financial Stability Oversight Council (FSOC) and generally should be given similar authority as the FDIC and Federal Reserve over systemically important entities under the Dodd-Frank Act. The regulator should be required to consult with FSOC before placing a systemically important secondary market participant into conservatorship. To the extent not already the case under current law, any nonbank that is a participant in the secondary market should be subject to a possible systemically important designation, and should have to draft a "living will" if so designated. The new regulator should have a direct role in reviewing the living wills of any secondary market participant, as is the case with the FDIC and Federal Reserve. Where State-chartered entities, including insurance companies, are concerned, the company would be resolved under State law, but the Federal housing regulator would have the authority to step in to handle that resolution if the appropriate State authority did not take what the regulator deemed to be the necessary action, as is true of the FDIC's similar authority under the Dodd-Frank Act.

Servicing Standards

Credit unions should continue to be afforded the opportunity to provide mortgage servicing to their members in a cost-effective and member-service oriented manner, in order to ensure a completely integrated mortgage experience for credit union members. To lose this servicing relationship would be detrimental not only to a vast majority of credit union members, but could also result in fewer mortgage choices available to credit unions and their members, with higher interest rates and fees being imposed on both.

Initial national mortgage servicing standards will likely be part of the common securitization platform being developed under the auspices of FHFA. They should be applied uniformly and not result in the imposition of any additional or new regulatory burdens upon credit unions. Going forward, private market participants should be able to revise servicing standards subject to oversight by the FMIC.

The FMIC should have legal authority to ensure that the development and implementation of all servicing standards are reasonable and fairly applied for all servicers; the legislation should ensure that eligibility requirements, compensation to or fees collected from servicers are not strictly based on volume but also reflect other reasonable factors such as in the case of compensation, the performance of the loans serviced.

The mutual securitization company should have the authority to transfer mortgage servicing rights but FMIC should be empowered to oversee the process and resolve issues of concern. Tracking of servicing rights is already provided in the private sector and there is no need to require the mutual securitization company or the FMIC to undertake this function.

To ensure that all servicers are treated fairly and appropriately by the mutual securitization company, the legislation should establish an ombudsman to interact with servicers and create a review process under which complaints raised by servicers will be investigated and resolved in a timely manner.

The regulation of servicing should be bifurcated with the FMIC overseeing how standards for servicing necessary to support securitization are developed while the protection of consumers in the servicing process should be left to the CFPB. In other words, the FMIC should not be granted authority to impose any additional consumer protection servicing requirements on regulated financial institutions that service mortgage loans. Such protections have already been established under a statutory and regulatory framework under the purview of the CFPB. While improvements to the current framework, such as changes to the servicers' exemption levels to ensure regulatory burdens on smaller servicers are minimized, should be considered, the regulation and oversight of the servicing process, including standards, should be left to the CFPB.

Transition Issues

The transition from the current system to any new housing finance system must be reasonable and orderly. We urge the Committee to allow for as much time as possible for the mutual to establish itself as a dominant market participant, for investors to acquire confidence in the securities issued by the mutual. The transition should end when the new system is fully functional, rather than after any specified period. Further, we recommend that the common securitization platform now being developed under the direction of the FHFA should be available to all market participants. Finally, once the earnings of the GSEs have fully paid back all Government costs of their conservatorship, any further GSE earnings during the transition should be available to cover costs of standing up the new system, and beginning the funding of the reserve balance of the FMIC.

Unless the mutual is a dominant player in the market, it runs the risk of withering. Therefore, we feel strongly that the mutual should be fully operational before either of the GSEs are shuttered. Indeed, we expect that much of the infrastructure of the two GSEs will likely be transferred to both the mutual and FMIC during the transition.

The Federal Credit Union Act limits the types of investments that credit unions can hold. Since Government agency securities are one of the few investments allowed, they tend to purchase and hold many of these securities. Therefore, in order to ensure the safety and soundness of credit unions, and to ensure the new FMIC securities perform on par as the current GSE securities we suggest a phased in approach to issuing the new security that would be blended with the Fannie and Freddie issued securities to ensure the investments hold their value and market stability is maintained.

To minimize market disruption, we would suggest that Fannie Mae, Freddie Mac, and the FMIC be allowed to operate simultaneously so that all parties can get acquainted with the new system. In addition to gaining familiarity with the new system, it would be appropriate for both the GSEs and the FIMC to start issuing securities with each trying to mirror or have very similar characteristics of the other. As the last step in the process before Fannie Mae and Freddie Mac are wound down, blending the two securities together and selling them for a period of time under the new FIMC name may provide the market the necessary time to become comfortable with the new security. Ideally, market participants will not notice any sudden changes on the day that the GSEs are shuttered and the new system takes over. The many changes necessary to move from the old to the new system would already have happened gradually during the transition.

Finally, the common securitization platform now being developed under the direction of the FHFA should be available to all market participants. It could be "owned" and controlled by the mutual securitization company, or a separate mutual could make up of all issuers of covered securities. Its use should be required for all covered securities, which would likely make it the default for PLS. Regardless of who owns it, if its use were required for all covered securities, the FMIC would have de facto regulatory control over it.

Additional Concerns Specific to Credit Unions

Statutory limitations restrict the ability of credit unions to more fully serve their members and may inhibit their ability to be complete participants in the reformed housing finance system. Therefore, we would strongly encourage the Committee to consider the following statutory changes specific to credit unions as part of the reform of the housing finance system.

Investment Authority

As noted above, the Section 107(7) of the Federal Credit Union Act (12 U.S.C. 1757(7)) limits the types of investment that Federal Credit Unions may make to loans, Government securities, deposits in other financial institutions, and certain other limited investments. We believe that credit unions may need additional investment authority in order to capitalize the mutual envisioned by S.1217, and we encourage the Committee to provide that authority.

Multifamily Housing

In discussions prior to this hearing, CUNA was asked about the impact of S.1217 on multifamily housing credit availability and pricing. Credit unions are not significant participants in the multifamily mortgage market primarily because of the statutory cap on business lending imposed in 1998. This cap limits credit unions business loan portfolio to essentially 12.25 percent of the credit unions assets. Compounding the matter, the Federal Credit Union Act considers a loan made on a 1–4 family nonowner occupied residence a business loan; whereas the same loan made by a bank would be considered a residential loan. Comprehensive housing finance reform legislation may provide the opportunity to correct this disparity in the statute. We encourage the Committee to include language that would amend the Federal Credit Union Act and consider loans made on 1–4 family residential properties as residential loans.

Relief From Dodd-Frank Act Mortgage Regulations

As Congress considers comprehensive housing finance reform legislation, it also may be prudent to consider changes to Dodd-Frank Act related mortgage regulations. The CFPB has finalized many thousands of pages of regulations with which credit unions and other community-based financial institutions must comply, despite the fact that they did not cause the mortgage crisis and have, throughout history, employed the strong underwriting principles the rules are designed to require.

The compliance obligations imposed by these rules—some of which were finalized in September and are effective in January—are simply overwhelming to many credit unions, and the tight timeframe for compliance puts the availability of mortgage credit at risk. While there has been suggestion by the CFPB and other regulators that they may not cite financial institutions for noncompliance for a period of time after the compliance date, the law carries a private right of action which would make credit unions and others vulnerable to lawsuits for noncompliance even as they work in good faith toward compliance. Another year would ensure that mortgage credit remains available to millions of credit union members while credit unions all over the country continue to understand how to implement the most sweeping regulatory changes to mortgage lending in U.S. history, and would be welcome relief to credit unions. We encourage Congress either through this legislation or as a separate bill to address this issue.

In addition to addressing the compliance dates of the mortgage regulations, we encourage the Committee to address several other areas of the mortgage regulations, including the definition of points and fees for the purposes of the CFPB's ability-to-repay rule, the credit risk retention requirements for the "qualified residential mortgage" rule and changes to the qualified mortgage rule.

We note that Senator Manchin has introduced S.949, the Consumer Mortgage Choice Act, which would exclude from the definition "all title charges, regardless of whether they are charged by an affiliated company, provided they are bona fide and reasonable." Defining points and fees in this way will maintain a competitive marketplace, prevent overpricing or limited choice in low-moderate income areas and allow consumers to enjoy the existing benefit of working through one entity for their new mortgage or refinance. A statutory revision would make this definition clearer and stronger than the CFPB's amended rule.

We hope the Committee will also consider including language in the housing finance reform bill to repeal the credit risk retention requirement in the "qualified residential mortgage" rule, and to allow the consumer to waive the requirement that mortgage disclosures be provided to the consumer three business days before closing.

Finally, we encourage the Committee to consider language to repeal the defense to foreclosure provision of the Dodd-Frank Act. The litigation risk created by the defense to foreclosure provision has caused many credit unions to worry that prudential examiners will severely restrict the ability of credit unions to keep non-QM loans that do not enjoy the QM rule's safe harbor in their portfolio after the rule goes into effect. This would make QM the effective requirement for safety and soundness and risk mitigation purposes. These changes would do a great deal to alleviate the very real concern of credit unions that they will not be able to offer mortgages to their members who do not meet all of the QM standards but who nevertheless have the ability to repay a mortgage loan. These changes will also help facilitate the kind of creative products that are possible through portfolio lending that individualize the process of getting a mortgage based on the individual circumstances of each member.

Conclusion

We are encouraged that the Committee has engaged in a process to consider comprehensive housing finance reform. Unquestionably, the housing finance system is in need of repair, and it is critical that Congress get reform legislation right or risk further damage to an already fragile economy. We appreciate that the Committee has sought our views on this legislation and look forward to providing continued assistance as the legislation moves through the process. On behalf of America's credit unions and their 97 million members, thank you for your consideration of our views.

PREPARED STATEMENT OF BILL COSGROVE

CHIEF EXECUTIVE OFFICER, UNION HOME MORTGAGE CORP., AND CHAIRMAN-ELECT, MORTGAGE BANKERS ASSOCIATION

NOVEMBER 5, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, my name is Bill Cosgrove and I am a Certified Mortgage Banker. I currently serve as Chief Executive Officer of Union Home Mortgage Corp., headquartered in Strongsville, Ohio, and I am the Chairman-Elect of the Mortgage Bankers Association.[1] I own and operate a family owned business, and have been an independent mortgage banker for 28 years. My company employs 278 individuals, and I am very proud that since I purchased the company in 1999 we have helped more than 50,000 homebuyers finance and refinance their homes and achieve their dreams of home ownership.

Importance of Small Lenders to the Housing Finance System

Small lenders play a crucial role in the American housing finance system. More than 7,400 lenders originated mortgages in 2012 according to the Home Mortgage Disclosure Act (HMDA) data. The vast majority of these were small lenders with vital ties to their communities.

Fannie Mae and Freddie Mac report that roughly 1,000 lenders are direct sellers to the GSEs, and Ginnie Mae currently has more than 250 single-family issuers. The vast majority of these loan originators are smaller independent mortgage bankers and community banks. In fact, according to the most recent data, while independent mortgage banks represent only 11 percent of lenders who report under HMDA, this group originated 40 percent of all purchase money mortgages in 2012. Over the course of the next year, this group, and small lenders as a whole, will become increasingly important as we transition from a predominately refinance market to a primarily purchase market.

It is important to recognize that not all small lenders have the same needs when it comes to accessing the capital markets for mortgages. For example, not every smaller lender has the financial capacity or expertise to directly manage the risks and complexities of the secondary market. Rather than deal with the GSEs directly, these small lenders prefer instead to sell whole loans to aggregators. Many community banks are uncomfortable selling only to aggregators as they do not want to risk losing other key product relationships with their customers. And still others, like my company, desire to issue securities or sell whole loans based on the execution option that results in the best price for the customer. For most community lenders, it is critical to have direct access to the secondary market as an additional tool to ensure competition and an outlet for loans at times when the aggregators pull back.

Lenders with the skills and the capital should be in a position to make their own choices about how, when, where, and to whom to sell their production, based on their core competencies and other strategic objectives. Unfortunately, current GSE practices today sometimes limit the choices of otherwise qualified lenders.

Options for the End-State Framework

Under the current GSE model, Fannie Mae and Freddie Mac are the issuers. They purchase loans from lenders and provide a guarantee (backed by an implicit Government guarantee).

Under the Ginnie Mae model, lenders are the issuers. Lenders obtain loan-level insurance from a Government program (FHA, VA, USDA) and then issue the securities, obtaining a security-level guarantee from Ginnie Mae.

The GSE model provides for many, typically smaller, lenders to sell whole loans to Fannie Mae and Freddie Mac for cash. This provides quick funding, which is a valuable benefit for many smaller lenders.

The Ginnie Mae approach puts greater responsibility and control with the lender. However, the operational complexities may prevent some smaller lenders from becoming issuers. As a reference, there are roughly 400 Ginnie Mae issuers, and over 1,000 direct sellers to Fannie and Freddie.

It is important to note that both options can be made to work well for smaller, community-based lenders, provided policy makers address the issues outlined below.

Making the Secondary Market Work Better for Smaller Lenders

In the past few years, as the mortgage market has begun stabilize, more small lenders have chosen to diversify their secondary market options by selling directly to the GSEs, and retaining the servicing on the loans they originate. This has been

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, DC, the association works to ensure the continued strength of the Nation's residential and commercial real estate markets; to expand home ownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies, and others in the mortgage lending field. For additional information, visit MBA's Web site: *www.mba.org*.

a healthy trend, and an early sign that the market has begun to deconsolidate. The GSEs have already substantially increased their qualification standards in the postcrisis period for lenders with respect to minimum net worth requirements. It is important to note that further increases in net worth standards for small lenders would block direct access to the secondary market for critically important community lenders.

As policy makers consider both transitional and end-state reforms, the future secondary market needs to provide direct access, on competitive terms, for those lenders who can take on the requisite responsibilities. In particular, smaller lenders need a secondary market that delivers:

- Price certainty, including guarantee fees that reflect the risk of the underlying loan (and not the loan volume or the asset size of the lender);
- Execution for both servicing-retained and servicing-released loans;
- Single loan and/or small pool executions with a low minimum pool size;
- Ease of delivery;
- Quick funding.

Fannie Mae's and Freddie Mac's cash windows provide some, though not all, of these aspects today. While Ginnie Mae provides a means of securitizing single loans, the relative complexity of the process has kept many smaller originators from becoming direct issuers, thus the smaller number of Ginnie issuers relative to GSE direct sellers.

Price Certainty and Transparency

One major ongoing concern has been the pricing advantages (e.g., lower guarantee fees) and other preferences received by some lenders. These disparities contributed significantly to the consolidation of the lending market during the run-up to the financial crisis and in its aftermath. Although the FHFA has reported that these disparities have narrowed, there is little transparency on pricing and pricing concessions offered to certain lenders, despite the fact the enterprises are in their fifth year of conservatorship. Historically, certain lenders also received negotiated underwriting variances as well, which gave them additional competitive advantages.

MBA believes that FHFA should expedite efforts to eliminate any remaining pricing and underwriting concessions. In addition, end-state reforms should also ensure that the federally supported secondary market provides transparent pricing, programs and underwriting standards. Guarantee fees should reflect the risks of the underlying loans, and should not differ across qualified originators, except to reflect objective measures of counterparty risk. Access to programs and products should be made broadly available to all lenders that meet minimum standards, and any additional requirements needed to mitigate counterparty risk should be based on objective and transparent factors so that smaller lenders have a clear path to participate.

Pricing in the federally supported secondary market should be more transparent and calibrated to objective measures of loan-level and counterparty risk.

Execution Options for Smaller Lenders

Because of the risks associated with the GSEs' large retained portfolios, most proposals regarding the future of the federally backed secondary mortgage market do not envision the successors to the GSEs having large investment portfolios of mortgages. Today, the GSE cash windows provide lenders of all sizes a bid for whole loans. While this bid may not always be the best execution available in the market, it is open every business day, provides quick funding for lenders, and is relatively simple in terms of operational process. MBA believes secondary market reform needs to ensure that any successors to the GSEs retain small portfolios necessary to operate a cash window and aggregate multilender securities.

Some lenders who have achieved additional scale and sophistication want to pool and securitize their loans themselves in order to get a better "all-in" price. Beyond selling to the cash window, there are existing means for lenders to deliver small lots into multilender pools. The Ginnie II and the Fannie Majors programs both allow single loan execution.

However, these programs are more complex than using the cash windows, and thus only a small number of lenders utilize the programs. There is a need for simplification of these processes to make them more user-friendly for smaller lenders. For example, although multilender securities might not price as well in the capital markets as larger pools from a single lender, any discount could be reduced by pooling practices that increase the size of these multilender securities.

In addition, it is important for some smaller lenders that they have the option to securitize loans on either a servicing-released or retained basis. Currently, Fannie Mae and Freddie Mac have programs in place which facilitate bifurcation of originator and seller reps and warrants so that originators can deliver loans servicing-released. However, participation in these programs is tightly restricted. Such programs are necessary going forward, and should be made more broadly available to smaller lenders. MBA believes these programs do not need direct facilitation from any other player and that smaller sellers should be able to negotiate reps and warrants directly with any approved servicer.

Quick Funding

It is also important for smaller originators to have an option for receiving quicker funding. In the new system, there should be some consideration to moving to more frequent settlement dates to permit quicker funding. Broker dealers already provide a bid for off-settlement-date trades using interpolated pricing. The expectation is that this market could grow if more sellers utilize it. Direct sellers to the GSEs or issuers in the Ginnie Mae program must meet financial and managerial standards to be approved today. Smaller lenders who wish to be direct issuers will need to meet the issuer standards (net worth and other standards) set by the public guarantor in a future model. These standards need to be set at a level that allows for meaningful access by smaller lenders.

Key GSE Assets Should Be Preserved To Assist Small Lenders in a New System

As Congress considers broader reforms to the secondary market, care must be taken to ensure a smooth transition, and that "switching costs" to a new system do not create a major barrier to participation by smaller lenders. Key GSE assets, including technology, systems, data, and people, should be preserved and redeployed as part of any transition associated with GSE reform. For example, certain assets could be moved into the Common Securitization Platform. Other assets could be made broadly available through a public leasing program, or sold/auctioned with conditions that ensure access to all market participants.

In addition to the infrastructure assets, the following functions and support services should be retained in any new system:

A. Cash Window/Whole loan execution;

B. Multilender security execution;

C. Single-loan securitization;

D. Servicing retained sales; and,

E. Servicing released sales.

In addition, single-family lenders should be able to utilize familiar credit enhancement options, such as mortgage insurance, to facilitate secondary market transactions in a timely and orderly way. Key credit enhancement functions present in today's secondary market system should be preserved and improved, while allowing new forms of private credit enhancement to develop over time.

It may well take a combination of approaches to ensure that the system works for both smaller and larger lenders. It is imperative that the new system provide access on a competitive basis to qualified institutions, as this vibrant competition will ultimately benefit borrowers.

Role of FHLBs in a New System

Congress should give serious consideration to expanding Federal Home Loan Bank membership eligibility to include access for nondepository mortgage lenders. In fact, historical evidence shows that such a move is consistent with the original intent of the system.[2] These lenders are often smaller, community-based mortgage bankers or servicers focused on providing mainstream mortgage products and services to consumers. They are a critically important source of mortgage credit, especially for purchase market—the Fed's recent HMDA report shows that independent mortgage bankers accounted for 40 percent of home purchase lending in 2012.

The Federal Home Loan Banks have had an important role in providing long-term funding for institutions that hold mortgage loans on their balance sheets. In the future system, this role could be expanded to include shorter-term financing for the aggregation of pools of mortgage prior to securitization. This financing would become even more critically important if the end-state reform does not preserve a cash

[2] Professor Snowden notes that "Hoover had envisioned a Federal Home Loan Bank that would serve all institutional residential mortgage lenders, including commercial and savings banks, insurance companies, and mortgage companies. The USBLL did not however, and, in the end, Hoover's reliance on that organization limited the breadth and effectiveness of the FHLB system during the 1930s."

window option, but only if membership criteria for the FHLBs were expanded to include community lenders of a variety of business models, including independent mortgage bankers.

In exchange for membership in the FHLB system, these institutions could be required to hold a limited class of stock with appropriate restrictions. Expanding FHLB access to these institutions would enhance market liquidity and ensure a broader range of mortgage options for consumers, and improve the execution options for FHLB members as a whole.

Creation of a Mutual Organization

S.1217 proposes a system that is closer in many respects to the Ginnie Mae model. Lenders are issuers, and are responsible for obtaining private credit enhancement before delivering pools of loans to the central securitization platform for the Government guaranty. This approach may work for some lenders, but may be too operationally difficult for many smaller lenders. S.1217 provides an alternative for smaller lenders in the form of a mutual securitization company, a cooperative that takes the role of aggregator and issuer. S.1217 also provides for the FHLB system to be aggregators for smaller lenders.

The mutual could potentially fill the aggregation role for those lenders who do not have the operational capacity or desire to be an issuer. However, if Congress establishes appropriate parameters around capital requirements and credit standards and takes the proper steps to ensure small lender access throughout the core reforms, such as the execution options noted above, transparent pricing, and product access, a mutual structure may not be necessary. Regardless, broad standards for a mutual should ensure a fair governance process that does not advantage one class of mutual shareholders over another based on size or loan volume.

Questions arise regarding the economic model for the mutual. First, it appears that the mutual is likely a private, not a Government organization. As such, its cost of financing may be high. Without a favorable cost of funds, it is not clear whether the aggregation business could be run profitably and safely. Second, lenders working with the mutual would likely be required to maintain an equity stake in the cooperative. This represents an ongoing liability that would likely be difficult to liquidate if the lender needed funds. Certain mutuals provide for capital stock to be sold back at a par value, but this then increases risk for the mutual. In structuring any mutual entity intended for smaller lenders, it is important to ensure that it is not an inferior execution option that limits small lender competitiveness.

Finally, there are questions regarding membership criteria for the mutual. If this channel of execution is optimal, it should be open to all lenders in order to maintain a level playing field. In fact, there should be provision for the creation of additional issuer entities that could compete along various dimensions.

Transition to a New System

Transition to a new housing finance system should occur in a manner that avoids disrupting the market. Preserving the execution options for small lenders will be critical to a smooth transition. Extended phase-in periods will be necessary, and the new regulator should have some discretion and flexibility to extend those phase-ins if necessary to ensure a smooth transition.Standardized securities and transparent underwriting and guarantee fee pricing based on the risk of the mortgages, and not the volume or asset size of the selling institution, will ensure that smaller lenders have access to the federally supported segment of the secondary market.

As policy makers begin moving the market toward the desired end state for Fannie Mae and Freddie Mac—either through regulatory, administrative, or legislative actions—two items need particular attention.

First, the GSEs' current cash window needs to remain in place until the new secondary market delivery systems are fully operational. As the GSE portfolios wind down, sufficient balance sheet space needs to be maintained to aggregate loans from smaller lenders who are not yet ready to securitize. As noted, the new system must also have fully viable small lender execution options before winding down the existing cash window.

Second, the FHFA platform initiative needs to include plans for the acceptance of small lot deliveries into multilender pools, perhaps initially designed as an expansion of the Fannie Majors program. Every effort should be made to further simplify this program so that it can be a viable, competitive option for lenders of every size.

Rural Concerns

Small lenders—community banks, credit unions, and independent mortgage bankers—provide a critical link to rural communities. Maintaining access to the system in rural markets can be accomplished through the broader efforts to ensure small, community lender access to the new system. The use of percentage of business goals is too rigid, could lead to inappropriate risk assessment and would be subject to "counting" games that undermine their objectives and should not be used in the new system.

S.1217 clearly addresses many of the concerns of smaller lenders with respect to maintaining direct access to the secondary market on a competitive basis. S.1217 could be enhanced by requiring the new private credit enhancers to ensure small lender access through:

- a cash window for aggregation (not investment),
- additional small lender execution options like single loan and multilender pooling options, and
- requiring fair, transparent pricing and access for all lenders.

Care must also be taken with respect to certain issues, particularly around transition, to ensure that key assets of the GSE model are redeployed to the new system, ensuring liquidity, access, and a level playing field for lenders of all sizes.

Conclusion

Making the secondary market work for smaller lenders is critical for providing a competitive market, which ultimately benefits homebuyers. We are encouraged by the recent work undertaken by this Committee to tackle the complexities of housing finance reform, and urge you to ensure that secondary market reform provides smaller lenders with opportunities for direct access.

Thank you again for the opportunity to testify today, and for the chance to continue this critical dialogue with the Members of this Committee. I look forward to any questions you may have.

PREPARED STATEMENT OF JOHN HARWELL

ASSOCIATE VICE PRESIDENT OF RISK MANAGEMENT, APPLE FEDERAL CREDIT UNION, FAIRFAX, VIRGINIA, ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

NOVEMBER 5, 2013

Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. My name is John Harwell, and I am testifying today on behalf of the National Association of Federal Credit Unions (NAFCU). I appreciate the opportunity to share NAFCU's views with the Committee on, "Housing Finance Reform: Protecting Small Lender Access to the Secondary Mortgage Market". NAFCU appreciates the bipartisan approach Committee leadership and Members have demonstrated on this critical issue. In addition to our testimony, NAFCU member credit unions look forward to continuing to work with you beyond today's hearing to ensure access to the secondary mortgage market for credit unions and their 96 million members.

Throughout my career in financial services I have had a deep focus on home loans and have an understanding of credit union mortgage lending from a number of perspectives. I currently serve as the associate vice president of Risk Management at Apple Federal Credit Union (Apple FCU) in Fairfax, Virginia. Before joining the management team at Apple FCU, I was with FedChoice FCU and served in a number of capacities culminating in Membership Services Manager. Over the years, I have been involved in the mortgage lending process as a loan officer, branch manager, compliance officer and risk manager. In addition to my responsibilities at Apple FCU, I currently serve on the Board of Directors of the Metropolitan Area Credit Union Managers Association dedicated to continuing education for credit union personnel from executives to board volunteers.

Headquartered in Fairfax, Virginia, Apple FCU serves more than 161,000 members with assets totaling over $1.8 billion. With 21 branches across northern Virginia, Apple FCU provides diversified financial services including mortgage origination and servicing. Financial education is very important to Apple FCU, and we are known for our student-run credit union branches in Fairfax County schools where we are able to reach young people and teach them the importance of personal finance.

As you know, NAFCU is the only national organization exclusively representing the interests of the Nation's federally chartered credit unions. NAFCU-member credit unions collectively account for approximately 68 percent of the assets of all federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to participate in this discussion regarding housing finance reform. My testimony today will explore the longstanding vital relationships credit unions have with the Government sponsored enterprises (GSEs) and how important it is for any housing finance reform package to ensure credit union access to the secondary market under fair pricing conditions. Key issues in the housing finance reform debate for credit unions include:

- An explicit Government guarantee on mortgage-backed securities (MBS)
- Fair pricing and fee structures that reward loan quality
- Ensuring market feasibility of a mutual should such an entity be adopted in statute
- Flexible underwriting standards that will allow credit unions to best serve their members
- Adequate transition time to a new housing finance model

Background on Credit Unions and Credit Union Mortgage Lending

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the Federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to meet a precise public need—a niche credit unions fill today for over 96 million Americans. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 U.S.C. 1752(1)). While nearly 80 years have passed since the Federal Credit Union Act (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

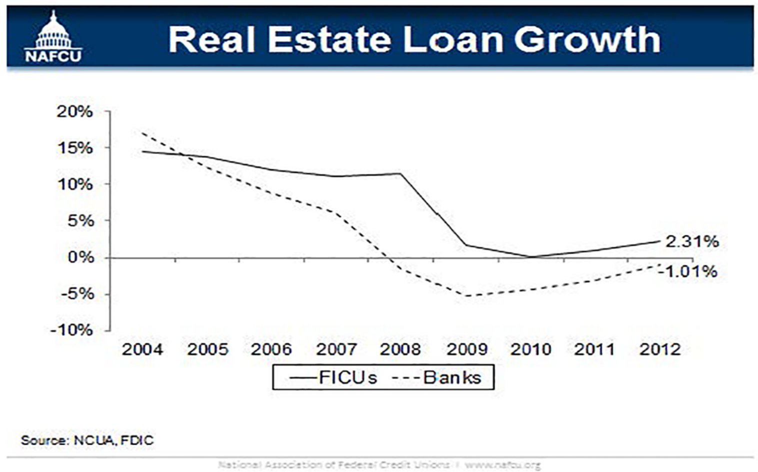
- credit unions remain totally committed to providing their members with efficient, low-cost, personal financial service; and,
- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism. Credit unions are not banks.

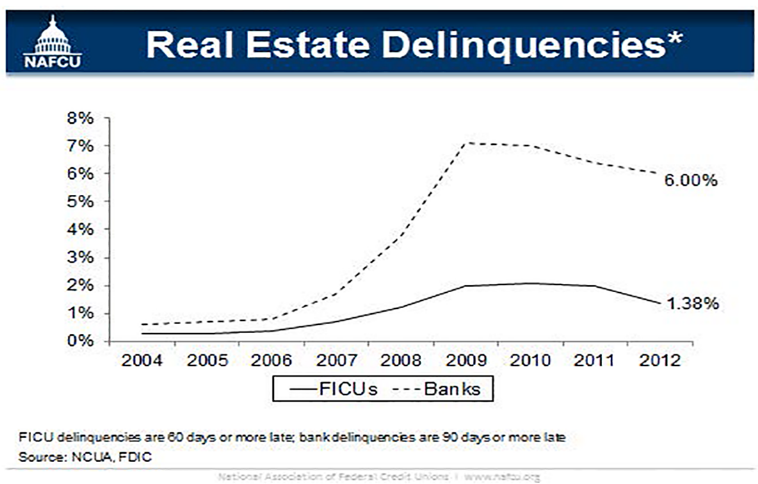
The Nation's approximately 6,700 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors—something unheard of among for-profit, stock-owned banks. Unlike their counterparts at banks and thrifts, Federal credit union directors generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

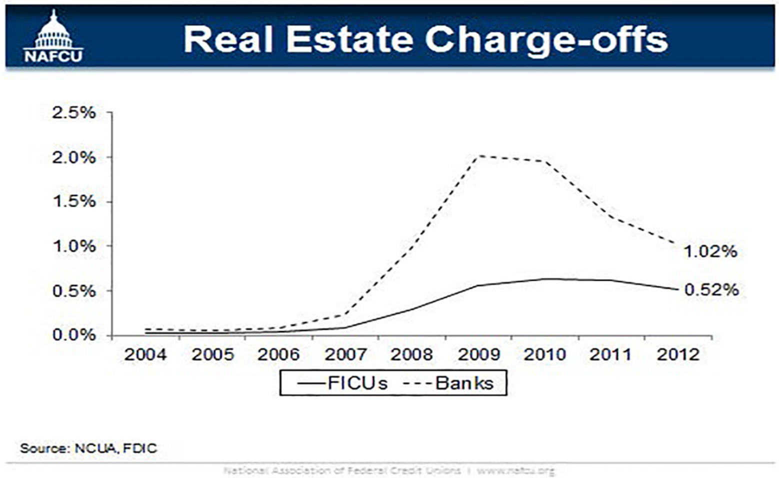
Credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation of the commercial banking sector has progressed, with the resulting depersonalization in the delivery of financial services by banks, the emphasis in consumers' minds has begun to shift not only to services provided, but also—more importantly—to quality and cost of those services. Credit unions are second-to-none in providing their members with quality personal financial services at the lowest possible cost.

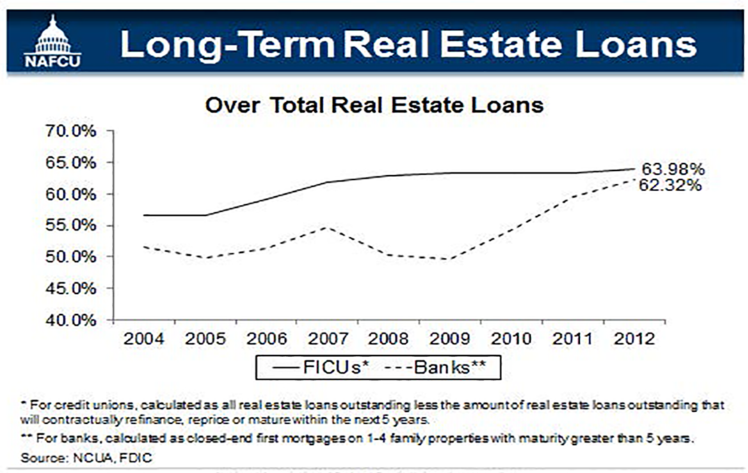
As has been noted by Members of Congress across the political spectrum, credit unions were not the cause of the recent economic crisis, and examination of their lending data indicates that credit union mortgage lending has outperformed bank mortgage lending during the recent downturn. This is due in part to the fact that credit unions were not the cause of the proliferation of subprime loans, instead focusing on placing their members in solid products they could afford.

While the housing market continues to recover from the financial crisis, and Congress works to put into place safeguards to ensure such a crisis never happens again, credit unions continue to be focused on providing their member-owners with the basic financial products they need and demand. The graphs below highlight how credit union real estate loan growth outpaced banks during the downturn, and how credit unions have fared better with respect to real estate delinquencies and real estate charge-offs. The fourth graph demonstrates how credit unions are holding more long-term real estate loans as a percentage of total real estate loans than banks. It is with this data in mind that NAFCU urges members of the Committee to recognize the historical performance and high quality of credit union loans as housing finance reform moves forward.

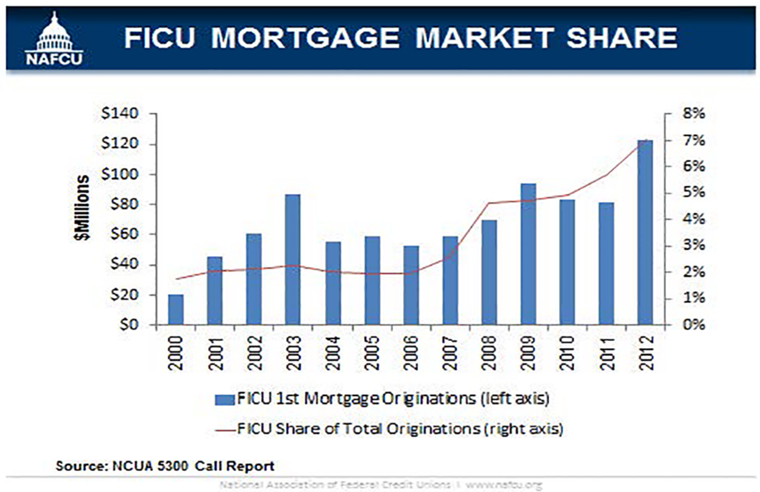

NAFCU
Real Estate Loan Growth
20%
15%
10%
5%
0%
-5%
-10%
2004
2005
2006
2007
2008
2009
2010
2011
2012
2.31%
-1.01%
FICUs
Banks
Source: NCUA, FDIC
National Association of Federal Credit Unions | www.nafcu.org


NAFCU
Real Estate Delinquencies*
8%
7%
6%
5%
4%
3%
2%
1%
0%
2004
2005
2006
2007
2008
2009
2010
2011
2012
6.00%
1.38%
FICUs
Banks
FICU delinquencies are 60 days or more late; bank delinquencies are 90 days or more late
Source: NCUA, FDIC
National Association of Federal Credit Unions | www.nafcu.org

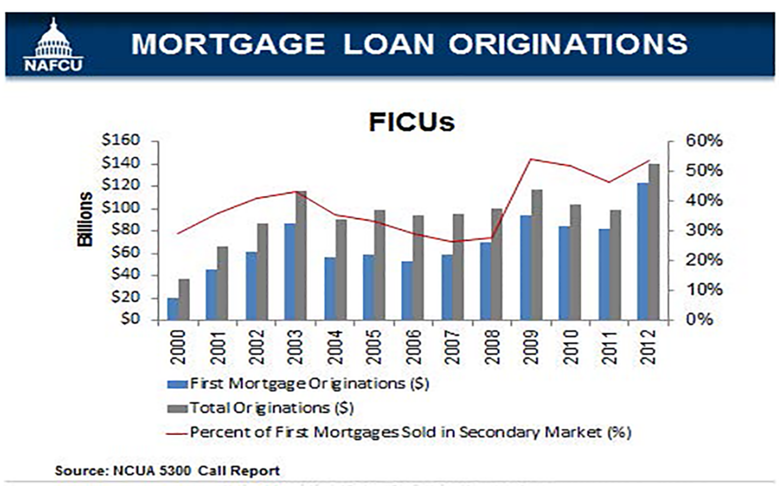




As Committee discussions on this topic continue, a primary concern of credit unions is continued unfettered access to the secondary mortgage market including adequate transition time to a new system should lawmakers see such a change necessary. A second concern, equally as important, is recognizing the quality of credit union loans through a fair pricing structure. Because credit unions originate a relatively few number of loans compared to others in the marketplace—federally insured credit unions had about 7 percent of the first mortgage originations in 2012 (see chart below)—they cannot support a pricing structure based on loan volume, institution asset size, or any other geopolitical issue that will lend itself to discrimination and disadvantage their member-owners.

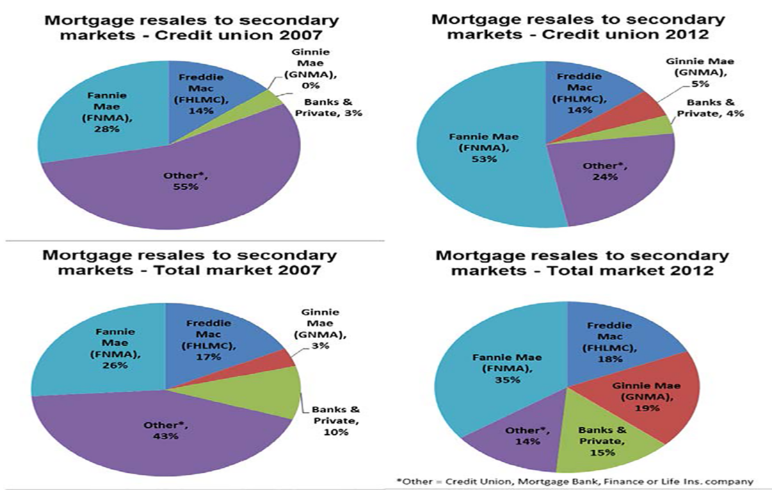


Recent trends in asset portfolios, coupled with the current interest rate environment, present a unique challenge to credit union management. In the past few years, interest rates have fallen to record lows, credit unions have experienced vigorous share growth and credit union participation in the mortgage lending arena has increased to historic heights. Credit union mortgage originations more than doubled between 2007 and 2013, and the credit union share of first mortgage originations expanded from 2.5 to about 7 percent. The portion of first mortgage originations sold into the secondary market also more than doubled over that same period, from 25.7 percent in 2007 to 53.6 percent in 2012, according to National Credit Union Administration (NCUA) call report data (see chart below).



While credit unions hedge against interest rate risk in a number of ways, selling products for securitization on the secondary market remains a key component of safety and soundness. Lenders must have continued and unfettered access to secondary market sources including Fannie Mae, Freddie Mac, Ginnie Mae, and the Federal Home Loan Banks (FHLBs) as they are valuable partners for credit unions who seek to hedge interest rate risks by selling their fixed-rate mortgages to them on the secondary market. Not only does this allow credit unions to better manage risk, but they are also able to reinvest those funds into their membership by offering new loan products or additional forms of financial services. A 2012 NAFCU real estate survey highlights the growing use of GSEs among credit unions. More than three-quarters of respondents indicated that credit union board policy restricted the percentage of real estate loans that could be held on their balance sheet, with a median limitation of 35 percent. Without these critical relationships credit unions would be unable to provide the services and financial products their memberships demand and expect.

Home Mortgage Disclosure Act data shows how heavily credit unions have come to rely on the GSEs. Between 2007 and 2012, the portion of credit union first mortgages that were sold to Fannie Mae grew from 28 percent to 53 percent. The portion sold to Freddie Mac remained a constant 14 percent over the same period. Credit unions sold a total of 67 percent of their first mortgages to the GSEs in 2012. The total market for mortgage resales is also heavily dependent on the GSEs. The portion sold to Fannie Mae and Freddie Mac in 2007 was 43 percent in 2007 and 53 percent in 2012.



Finally, it should also be noted that the Government plays an important role in helping to set standards and bring conformity to the housing market. Changing standards to eliminate or make conformity difficult could make it harder for credit unions to sell loans onto the secondary market as they do not have the economies of scale larger market participants enjoy.

Key Credit Union Concerns in Housing Finance Reform Efforts

In 2010, as the future of housing finance became a focal point in Congress, with the Administration, and among the regulatory agencies, the NAFCU Board of Directors established a set of principles that the association would like to see reflected in any reform efforts. The aim of these principles (listed below) is to help ensure that credit unions are treated fairly during any housing finance reform process.

- NAFCU believes a healthy, sustainable and viable secondary mortgage market must be maintained. Credit unions must have unfettered, legislatively guaranteed access to such a market. In addition, in order to achieve a healthy, sustainable and viable secondary market, NAFCU believes there must be healthy competition among and between market participants in every aspect of the secondary market. Market participants should include, at a minimum, multiple Government Sponsored Enterprises (GSEs), Federal Home Loan Banks, Ginnie Mae (as insurer of FHA, VA, and other Government-backed loans), and private entities.
- The U.S. Government should issue explicit guarantees on the payment of principal and interest on MBSs. The explicit guarantee will provide certainty to the

market, especially for investors who will need to be enticed to invest in the MBSs and facilitate the flow of liquidity.

- During any transition to a new system (whether or not current GSEs are to be part of it) credit unions must have uninterrupted access to the GSEs, and in turn, the secondary market.
- Credit unions could support a model for the GSEs that is consistent with a co-operative or a mutual entities model. Each GSE would have an elected Board of Directors, be regulated by the Federal Housing Finance Agency, and be required to meet strong capital standards.
- A board of advisors made up of representatives from the mortgage lending industry should be formed to advise the FHFA regarding GSEs. Credit unions should be represented in such a body.
- While a central role for the U.S. Government in the secondary mortgage market is pivotal, the GSEs should be self-funded, without any dedicated Government appropriations. GSE's fee structures should, in addition to size and volume, place increased emphasis on quality of loans and risk-based pricing for loan purchases should reflect that quality difference. Credit union loans provide the high quality necessary to improve the salability of many agency securities.
- Fannie Mae and Freddie Mac should continue to function, whether in or out of conservatorship, and honor the guarantees of the agencies at least until such time as necessary to repay their current Government debts.
- NAFCU does not support full privatization of the GSEs at this time because of serious concerns that small community-based financial institutions could be shut-out from the secondary market.
- The Federal Home Loan Banks (FHLBs) serve an important function in the mortgage market as they provide their credit union members with a reliable source of funding and liquidity. Reform of the Nation's housing finance system must take into account the consequence of any legislation on the health and reliability of the FHLBs.

Mortgage Lending at Apple FCU

Apple FCU currently has over 3,150 loans and $720 million in total mortgage loan originations outstanding. About a third of our loans are sold on the secondary market to Freddie Mac. Apple FCU has maintained the servicing on those loans, as it is important to us to keep that interaction with our members. The 30-year fixed-rate mortgage is an important product to our membership and is a close second to the 15-year fixed-rate in being our most common type of first trust. We currently hold over 600 30-year fixed-rate mortgages in portfolio. Any change to housing finance should be done in a way that helps preserve this product for credit union members in the marketplace.

NAFCU's Perspective on Emerging Senate Debate

NAFCU applauds Chairman Tim Johnson and Ranking Member Mike Crapo for their work in addressing solvency of the Federal Housing Administration earlier this year, and their continued bipartisan attention to housing policy as the Banking Committee agenda aggressively pursues housing finance reform ideas from the perspective of all stakeholders. We would also like to recognize the work of Senators Mark Warner and Bob Corker, and the Members of this Committee who have cosponsored their legislation, for laying the foundation for housing finance reform with the introduction of the "Housing Finance Reform and Taxpayer Protection Act of 2013" (S.1217). As you know, this legislation has the support of several Committee Members and provides for an explicit Government guarantee on qualifying mortgage-backed securities in a reformed secondary market.

The Importance of Maintaining a Government Guarantee

NAFCU and its member credit unions have examined various proposals for reform of the housing finance system and have reached the conclusion that we cannot support any approach that does not maintain an explicit Government guarantee of payment of principal and interests on mortgage-backed securities (MBS). The explicit guarantee will provide certainty to the market, especially for investors who will need to be enticed to invest in the MBS and facilitate the flow of liquidity in times of economic uncertainty. We think the approach found in S.1217 where private capital stands in front of the guarantee is workable, and believe this type of approach offers a viable public–private solution.

Key Elements of the Current System

Fannie Mae and Freddie Mac play important roles in the ability of credit unions to offer mortgage loans to their membership. A major part of this comes from the ease of transaction credit unions currently experience when using software provided by Fannie Mae and Freddie Mac.

At Apple FCU, we underwrite to Freddie Mac guidelines using their Loan Prospector program. The Loan Prospector program is used for all mortgage loans including jumbo loans. Our Lending operating system is called MortgageBot. Mortgage lenders and investors make a lending decision by looking at some basic factors: a person's capacity to repay a loan, a person's credit experience, the value of the property being financed, and the type of mortgage. Freddie Mac's Loan Prospector program dramatically speeds up the mortgage lending process and reduces the cost of getting a mortgage by using statistical computer models based on traditional underwriting factors. Loan Prospector never uses factors such as a borrower's race, ethnicity, age, or any other factor prohibited by the Nation's fair housing laws. This type of digital underwriting and standardization makes the entire process user friendly must be maintained in any new system.

While digital underwriting and standardization provide for ease of transaction, it should be noted that becoming an approved lender through Freddie Mac is not an easy process. While NAFCU understands and supports thorough requirements to ensure unscrupulous lenders are kept out of the marketplace, lawmakers must recognize the considerable amount of time it can take to become an approved lender at the various GSEs and account for such time in a transition to any new system.

Furthermore, even though Apple FCU is not currently using it, the function of the cash window at the GSEs as a single loan execution process is also vital to credit unions moving forward.

S.1217 and the Creation of the New Federal Mortgage Insurance Corporation

As the Committee is aware, S.1217 would replace the Federal Housing Finance Agency (FHFA) with a new Federal Mortgage Insurance Corporation (FMIC). The legislation also establishes a new statutory conforming loan limit of $417,000 for a single family residence. NAFCU has concerns about the impact this could have on the availability of loans in high-cost areas. NAFCU asks the Committee to consider if it is best to have the conforming loan limit defined in statute, or could it be better served by being evaluated and established by the regulator?

Any number of governance models could be sufficient should the new Federal Mortgage Insurance Company (FMIC) envisioned in S.1217 become a reality. If there is a single director at the FMIC, NAFCU believes there should an advisory board with at least one dedicated credit union representative. If the FMIC is governed by a board, there should be at least one credit union representative on the board. It should be noted that prior to the financial crisis, credit unions didn't always have an equal voice at the GSEs (due to limited volume) to assure pricing from the GSEs that reflected the quality of credit union loans. The changes that occurred during the crisis helped mitigate this concern, and we hope that continues under a new system.

While NAFCU appreciates the recognition of "community based financial institutions" in statute, it's imperative that legislative text is explicit in requiring robust experience specifically in the credit union space.

Funding of the FMIC should be done in a way as to limit the cost to financial institutions as much as possible. NAFCU believes it would be important to have an office at the new regulator with a dedicated focus and expertise on the needs of community institutions such as credit unions. In its reports to Congress, NAFCU supports credit union specific language on how the FMIC has provided liquidity, transparency, and access to mortgage credit in support of a robust secondary mortgage market and production of RMBS. As the FMIC establishes a fee structure, small financial institutions appreciate the clarification in statute that fees established by the FMIC should be "uniform" and can't be based on "volume to be purchased by an issuer." NAFCU believes it is critical to have a fee schedule that rewards loan quality, and we would support going further to expressly state this in the bill.

The FMIC would also have the ability to approve issuers. NAFCU would support clarification in statute that credit unions can securitize loans. While the NCUA is considering regulations in this regard, statutory clarification could help clear up any ambiguity.

S.1217 and the Proposed Mutual Securitization Company

In the context of S.1217, NAFCU believes the concept in Sec. 215 of the legislation that establishes the FMIC Mutual Securitization Company is a workable solution.

It is important that such an entity would help ensure that there is guaranteed access to the secondary market at all times for all credit unions. As noted above, while the NCUA is contemplating giving credit unions the ability to securitize mortgages, such authority does not currently exist. Therefore, the functions that the mutual would perform are especially vital to credit unions, as well as community banks and other small lenders, to help ensure access to the secondary market. We applaud the supporters of S.1217 for including this key element, especially Senators Jon Tester and Mike Johanns for their leadership in this area.

While NAFCU believes that the mutual is a viable option, there are ways that it can be improved. NAFCU has concerns about the $15 billion cap for participation in the mutual that exists in S.1217 as entities below this arbitrary asset size threshold will be unable to generate enough volume to ensure liquidity. NAFCU has suggested that, if there is a cap, it should be much higher (no less than $250 billion) to give most regional banks the opportunity to participate and generate the volume needed for the mutual to be successful.

In terms of an approval process for entities to participate in the mutual, standards could be set out by the new mutual board of directors, which should be elected by the membership. The board should include credit union representation (including at least one Federal credit union representative) that is proportionately equal to other industry representatives on the board. Furthermore, since the mutual would be the guaranteed route to access the secondary market for small lenders, especially in difficult times, it is important that there be a streamlined process to become a member. Conversely, we also believe it should not be made too difficult for an entity to leave the mutual should they desire.

Credit unions did not cause the financial crisis, and NAFCU believes that historical mortgage lending data should be taken into account as the secondary mortgage market is reformed. NAFCU believes that fee structures associated with the mutual, whether it is to capitalize or to sustain the mutual over time, should be based on loan quality as opposed to the volume of loans an entity is able to generate. If politically feasible, Congress should consider the mutual having some type of Government seed money that will help the mutual get off the ground and encourage qualifying entities to participate from day one. Such funds could be paid back over a period of years from the profits of the mutual.

NAFCU believes it would be viable to have the mutual be governed by the new Federal Mortgage Insurance Corporation (FMIC) as outlined in S.1217. It should be noted NAFCU believes the mutual's board of directors should be empowered to make day-to-day operating decisions and that it should be self-regulated to the greatest extent possible.

Finally, the new mutual will likely need technology and/or other infrastructure from the current GSEs to begin operations. NAFCU believes that sale of technology to the mutual should be done at the most reasonable price possible. The pricing and sale of technology will have a direct impact on the costs necessary to capitalize the mutual.

The Role of Federal Home Loan Banks (FHLBs) in S.1217

The Federal Home Loan Banks serve an important function in the mortgage market as they provide their credit union members with a reliable source of funding and liquidity. Reform of the Nation's housing finance system must take into account the consequence of any legislation on the health and reliability of credit unions.

NAFCU supports the FHLBs being one option for credit union access to the secondary mortgage market as proposed in S.1217. Currently, about 17 percent of credit unions belong to their regional FHLB.

Whether or not a credit union would use their FHLB membership as a primary channel to access the secondary market would be subject to many factors, including the current relationship between the credit union and their FHLB. Because the extent to which credit unions that are a member of their FHLB utilize current services varies greatly, we would expect the same should FHLBs become issuers in a new housing finance system. While NAFCU is supportive of the idea, we believe this cannot be the only mechanism in place for credit unions to gain access to the secondary market. Other options such as the proposed mutual and private placement must be available to credit unions as well. Having multiple options will allow credit unions to choose the avenue that works best for them and help ensure a healthy competition for their loans, which can help with fair pricing.

Transition to a New Housing Finance System

Should Congress act to reform the Nation's housing finance system, getting the transition right will be critical. More than anything, to ensure a smooth transition to a reformed secondary mortgage market, credit unions need certainty that changes outlined in legislation and accompanying regulation will function as intended. Credit unions must be kept up-to-date during this transitional period and lawmakers should build flexibility into the transitional period to account for unforeseen implementation challenges. NAFCU believes that Congress should first agree on a set of reforms and then, based on the nature and complexity of such reforms, establish a timeframe for transition. Arbitrarily pledging to adhere to a transitional timeframe before a set of reforms are agreed upon could create otherwise avoidable issues for new entities created under the bill and outside stakeholders.

In an effort to ease the transition, Congress should consider moving currently approved Fannie and Freddie lenders into a new system en bloc and giving them an expedited certification. This could reduce confusion and, if executed properly, could make the process run more smoothly for all involved. It can take time for lenders to be certified with the GSEs, and this time to certify, whether to the GSEs or to a new system, should be factored in to the transition time.

NAFCU also believes it is important that a new system be up and running before the ability of Fannie Mae and Freddie Mac to guarantee MBS is shut down. One way to accomplish this may be to have the two entities exist in a winding down capacity during the first 6 months of a new system. For example, they could still collect mortgages from lenders and move them through a new mutual to test the process. Lenders could use them and/or transition to the mutual or other options during this timeframe to allow for a smooth transition.

The Importance of Servicing Rights to Credit Unions

Any new housing finance system must contain provisions to ensure credit unions can retain servicing rights to loans they make to their members. While many turn to credit unions for lower rates and more palatable fee structures, they also want to work with a reputable organization they trust will provide them with high quality service. Because credit unions work so hard to build personal relationships with their members, relinquishing servicing rights has the potential to jeopardize that relationship in certain circumstances.

At Apple FCU, we currently retain servicing rights on all of our loans. This was especially beneficial during the economic crisis, as it allowed our members to approach us when they got in trouble and allowed us to work with them on their loan and keep them in their home. Furthermore, we believe the National Credit Union Administration, in conjunction with the FHFA or whatever entity replaces the FHFA moving forward, should set standards for other items important to small lenders. Such a process should be subject to public comment and take into account the operational expertise of small lenders. The Board of Directors of the mutual (should this idea be adopted) should also have a significant voice in the process.

Underwriting Criteria in Any New System

NAFCU has concerns about the "Qualified Mortgage" (QM) standard included in S.1217 for loans to be eligible for the Government guarantee. We believe underwriting standards may be best left to the new regulator and do not think that they should be established in statute. Doing so would allow the regulator to address varying market conditions and act in a countercyclical manner if needed.

Furthermore, given the unique member-relationship credit unions have, many make good loans that work for their members that don't fit into all of the parameters of the QM box. Using the CFPB QM standard for the guarantee would continue to discourage the making of non-QM loans.

In particular, NAFCU would support the following changes to the QM standard to make it more amenable to the quality loans credit unions are already making:

Points and Fees

NAFCU strongly supports bipartisan legislation in both the Senate and House to alter the definition of "points and fees" under the "ability-to-repay" rule set to take effect in January of next year. NAFCU has taken advantage of every opportunity available to educate and weigh in with the CFPB on aspects of the ability-to-repay rule that are likely to be problematic for credit unions and their members. While credit unions understand the intention of the rule and importance of hindering unscrupulous mortgage lenders from entering the marketplace, it is time for Congress to step in and address unfair and unnecessarily restrictive aspects of this CFPB rule.

NAFCU supports exempting from the QM cap on points and fees: (1) affiliated title charges, (2) double counting of loan officer compensation, (3) escrow charges for taxes and insurance, (4) lender-paid compensation to a correspondent bank, credit union or mortgage brokerage firm, and (5) loan level price adjustments which is an up-front fee that the Enterprises charge to offset loan-specific risk factors such as a borrower's credit score and the loan-to-value ratio. Making important exclusions from the cap on points and fees will go a long way toward ensuring many affiliated loans, particularly those made to low- and moderate-income borrowers, attain QM status and therefore are still made in the future.

Loans Held in Portfolio

NAFCU supports exempting mortgage loans held in portfolio from the QM definition as the lender, via its balance sheet, already assumes risk associated with the borrower's ability-to-repay.

40-Year Loan Product

Credit unions offer the 40-year product their members often demand. To ensure that consumers can access a variety of mortgage products, NAFCU supports mortgages of duration of 40 years or less being considered a QM.

Debt-to-Income Ratio

NAFCU supports Congress directing the CFPB to revise aspects of the "ability-to-repay" rule that dictates a consumer have a total debt-to-income (DTI) ratio that is less than or equal to 43 percent in order for that loan to be considered a QM. This arbitrary threshold will prevent otherwise healthy borrowers from obtaining mortgage loans and will have a particularly serious impact in rural and underserved areas where consumers have a limited number of options. The CFPB should either remove or increase the DTI requirement on QMs.

We would also like to caution against the perpetuation of the use of one brand of credit scoring model. Both Fannie Mae and Freddie Mac require loans that are underwritten using FICO scoring models. We believe any new system should be open to other possible credit scoring models as well.

Finally, NAFCU cautions against the 5-percent minimum downpayment requirement found in S.1217 for a loan to be Government guarantee eligible. Downpayment isn't the only indicator in determining underwriting soundness and we believe a hard downpayment requirement will reduce a lender's flexibility in matching consumers with a product that best suits their needs.

Loan Pricing

Prior to the financial crisis, credit unions did not always receive fair pricing based on quality from the GSEs for their loans, as many pricing models were based on volume. This has improved in recent years and NAFCU believes it is critical that this fair pricing based on quality is maintained in any new system.

Furthermore, while we would support the ability of the mutual to handle non-QM loans, and even support a guarantee program for non-QM loans (beyond the emergency power established in S.1217), NAFCU believes it is important that the pricing for these non-QM loans reflects the risks that they could pose to the system.

Conclusion

NAFCU appreciates the Banking Committee's bipartisan approach to housing finance reform and the inclusive nature of the process. While the proposal in S.1217 represents a positive step in the housing finance reform debate, we believe there are aspects of the bill that can be improved. In the end, whatever approach is taken to reform, it is vital that credit unions continue to have unfettered guaranteed access to the secondary market and get fair pricing based on the quality of their loans. The Government must also continue to play a role by providing some form of Government guarantee to help stabilize the market.

Thank you for the opportunity to provide our input on this important issue. NAFCU member credit unions look forward to working with Chairman Johnson, Ranking Member Crapo, Committee Members, and your staffs as housing finance reform legislation moves through the legislative process.

I thank you for your time today and would welcome any questions that you may have.

PREPARED STATEMENT OF JEFF PLAGGE

PRESIDENT AND CHIEF EXECUTIVE OFFICER, NORTHWEST FINANCIAL CORPORATION, ARNOLDS PARK, IOWA, AND CHAIRMAN, AMERICAN BANKERS ASSOCIATION

NOVEMBER 5, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, my name is Jeff Plagge. I am president and CEO of Northwest Financial Corp. of Arnolds Park, Iowa, and Chairman of the American Bankers Association. ABA represents banks of all sizes and charters and is the voice for the Nation's $14 trillion banking industry and its two million employees. Northwest Financial Corp is a privately owned, two banking holding company with approximately $1.6 billion in assets. We make between 3,000 and 3,500 mortgage loans per year, virtually all in our direct markets, and with the exception of Des Moines, IA, and Omaha, NE, are mostly in rural communities in Iowa. The majority of those loans are sold into the secondary market but we also portfolio loans as well, especially in some of our more rural markets due to loan size or some other issue that makes it difficult to work in the secondary market. It is a big part of our business model and any changes affecting mortgage lending are very important to us, our customers and our communities.

We appreciate the Committee's focus on ensuring that community banks like mine will continue to have access to a federally guaranteed secondary market. Such access is necessary to offer our customers the mortgage credit so vital to the economic health of every community across America. Small banks have always played an important role in mortgage finance. Community banks, with assets under $10 billion, hold over $530 billion (or nearly 23 percent of all 1–4 family residential loans held by the industry) and, of course, originate and sell billions of dollars of mortgages, primarily to Fannie Mae and Freddie Mac. These securities issued by Fannie and Freddie are bought by banks and are an important asset class for them, amounting to over $300 billion as of the second quarter of 2013. Perhaps, most importantly, in one out of every five U.S. counties, there is no other physical banking office except those operated by community banks, according to the FDIC Community Banking Study. Without these banks, residents of these communities will find mortgage credit harder to get and more expensive.

Reforming this segment of the mortgage market will be a complex undertaking with far reaching consequences for our economy. It must be undertaken in a thoughtful, orderly manner. We commend the Committee for the serious focus it continues to give these issues, and particularly the leadership of Senators Corker and Warner and the cosponsors of S.1217 in establishing a framework to build upon to reform the system. We believe that a Government guarantee on a limited segment of the market focused on low and moderate income mortgage borrowers is essential. That guarantee must be explicit, fully priced into the cost of each mortgage to which it applies, and, perhaps most importantly, available to all eligible primary market lenders, regardless of their size, charter type, geographic location, or number of loans sold into the secondary market. Community banks must remain able to access that guarantee. If these banks' access is curtailed or denied, or their pricing in the market is inequitable, they and the communities they serve will suffer.

As important as this Federal Government support is, going forward it should be within a mortgage market predominately filled by the private sector. Fostering and encouraging a private market for the vast majority of housing finance must be part and parcel of any Federal policy and should be balanced with Government support for certain market segments.

We believe that a mutual organization—if structured in an economically viable way and with appropriate governance—may be a promising approach to accomplish the goals of equitable access to secondary market liquidity for community banks—indeed all banks. In fact, in 2011, ABA wrote Treasury Secretary Geithner and HUD Secretary Donovan noting that a possible structure for a transition vehicle (and potential end point) for Fannie Mae and Freddie Mac could include: "a well-regulated and controlled cooperative structure owned by the financing entities or a similarly controlled secondary market public utility that is publicly owned." We went on to say that: "Whatever structure is chosen will require significant control and direction of guarantee fees, mission, investor returns and potential taxpayer liability. Activities under the structure will need to be confined to a controlled mission intended, among other things, to foster and accommodate development and expansion of private sector mortgage financing alternatives."

A multiplicity of access points to the Federal guarantee is desirable, with the mutual portal being one avenue. For example, many community banks also have existing relationships with larger institutions, through a correspondent or other arrangements, enabling them to sell mortgages that may be placed into a securitization at some point. Community banks should be able to sell into the mutual portal—even for only one loan—or continue to sell through other channels. The key point is that existing relationships and channels should not be harmed by any creation of a new portal to the secondary market.

One of the most important existing relationships, particularly for portfolio mortgage lenders, is the Federal Home Loan Bank System. A principle long held by ABA is that any reform of the secondary mortgage market must recognize the vital role played by the Federal Home Loan Banks and must in no way harm the traditional advance businesses of FHLBanks or access to advances by their members, particularly for community banks.

In your invitation letter, Mr. Chairman, you have raised many important questions about possible reforms. In answering these, I would like to frame the discussion under four main themes:

- Any reform of the GSEs must provide fair and equitable access to all primary market lenders selling into the secondary market;
- A mutual organization may be promising but must be economically viable and have the appropriate governance structure to assure fair and equitable access for all lenders—particularly community banks;
- An enhanced role for the FHLBanks holds promise, but must preserve and protect the system's current vital role; and
- A transition to a new system must ensure that mortgage markets are not destabilized.

Any Reform of the GSEs Must Provide Fair and Equitable Access to All Primary Market Lenders Selling Into the Secondary Market

ABA has long maintained that the primary goal of any Government involvement in the mortgage markets should be to provide stability and liquidity to facilitate the ability of banks and other primary mortgage lenders to provide home loans for creditworthy borrowers. This can only be achieved if there is fair and equitable access by all primary market lenders selling into the secondary market. In this regard, ABA commends the Committee for its attention to the concerns of small lenders and their ability to access secondary market funding, which has historically been difficult in some parts of the country. The overarching goal of reform legislation should be to ensure all eligible lenders—whether small, medium or large—have access to the Federal guarantee regardless of the number of loans they seek to sell, their geographic location, or the prevailing economic cycle. As market dynamics change it is not just small lenders who can potentially be disadvantaged and we want to work with you to ensure that banks of all sizes and charter types are able to equitably access the federally backed system that is contemplated.

A Mutual Organization Holds Promise but Must Be Economically Viable With Governance That Assures Equitable Access for All Banks

S.1217, legislation introduced by Senators Bob Corker and Mark Warner, and cosponsored by a number of Members of this Committee, contemplates at least two avenues of access to the Federal guarantee for smaller lenders—a mutual entity which would be chartered specifically for smaller entities and an expanded role for the Federal Home Loan Banks. While both of these approaches hold certain appeal, both come with risks and potential problems, not the least of which is capitalization. For example, a mutual open only to smaller lenders would be very difficult to sufficiently capitalize, as the potential members have limited available funds to contribute and the cost of capitalizing the mutual, if priced into the mortgages originated by such institutions, may well make them noncompetitive with other mortgage providers.

We would recommend that the Committee consider a third alternative, which would be the creation of a mutual entity which would not be limited to only small lenders. Under such a concept, a mutual would be created which would be open to all lenders who would have to buy into the mutual at a sufficient level to capitalize it. By expanding the potential membership, the base of potential capital may be expanded to a large enough degree that capitalization costs are more easily achieved. One key feature that must not be overlooked in developing such an entity is the ability of participants to be able to redeem their capital investment should they choose to leave the system, much like the redemption process allowed to members of the Federal Home Loan Bank system.

If a mutual were to be created as an access point to the Federal guarantee, it must be structured to ensure equitable access for all members, regardless of size or charter type. This would involve statutory mandates as to the mission, purpose, and activities of the mutual. It would also require a governance structure that balanced the rights and needs of members of all sizes and types. Under a mutual structure, larger members (and/or those members who engage in the most activity with the mutual) would have the larger investment and thus likely the larger number of shares to vote. This could lead to a "capture" or "dominance" of the mutual by these larger institutions. In order for the mutual to work for all members, it may not be able to function purely as an entity where members vote their shares regardless of size, but would need to have a governance system that balanced the rights and needs of all members. The Federal Home Loan Bank system can serve as one model for such governance. It is a system that is cooperatively owned, but which has complex governance rules which balance the needs and rights of all members.

Whatever structure is ultimately adopted, one feature that it must include is the ability to sell loans individually or in small numbers for cash. Some refer to this as the "cash window", and it is an essential feature for smaller lenders, or lenders who do not originate or sell large numbers of mortgage loans but still seek access to the secondary market. My bank sells loans via the cash window, as it is not only hard to have sufficient volume to execute our own mortgage-backed securities and the interest rate risk and pipeline management would be too high.

Sellers must also be able to retain servicing or sell it as best meets their needs. Our larger bank does retain servicing rights on many loans and we have built up our secondary market servicing portfolio over the past several years. We now service Freddie Mac loans totaling over $587 million. Our customers always prefer that we service their mortgages, but there are capital limitations for how much we can hold in mortgage services rights within our banks.

Any access point or points must ensure both the cash and servicing features are available and ensure that smaller lenders (or those lenders only selling small numbers of loans) are not disadvantaged through pricing on the loans themselves or the sale of the servicing. One of the actions taken by the Federal Housing Finance Agency as conservator of Fannie Mae and Freddie Mac was to eliminate volume pricing by the GSEs. This is an approach that must be continued in whatever new access points are established going forward. We encourage consultation with FHFA on their experiences in managing this outcome during conservatorship.

In your invitation letter, Mr. Chairman, you asked about a duty to serve underserved populations or geographies included in any new guarantee housing finance system. Banks already have such a mandate to serve all segments of their community through the Community Reinvestment Act. Similarly, their mortgage lending activity is tracked through the Home Mortgage Disclosure Act and banks are examined for compliance with both acts on a regular basis. No further duty to serve is needed for banks. Other lenders, be they credit unions or mortgage banks or other entities which are not currently required to meet similar mandates, should be subject to specific duties to serve in order to place all mortgage lenders seeking a Federal guarantee on a more equal lending footing and to help ensure more equitable lending choices for all borrowers.

An Enhanced Role for FHLBanks Must Preserve Its Current Vital Role

S.1217 also contemplates an expanded role for the Federal Home Loan Banks. While this should be considered, there are many issues that must be addressed. FHLBanks, as member-owned cooperatives, serve their large and small members very well, and are self-capitalized entities (and are in the process of increasing their reserves). However, this is capital which is already fully deployed and cannot be repurposed for new activities, absent the consent and direction of the members/owners of the System, or diluted in its capacity to absorb FHLB losses. In order to fully function as an alternative option to Fannie Mae and Freddie Mac—including taking on credit enhancement and securitization activities—the Federal Home Loan Banks would have to seek substantial additional capital from their members. Again, these institutions are unlikely to have the funds necessary to provide such capital, and if the cost of raising such capital were priced into mortgage originations, the mortgages may be unaffordable and noncompetitive.

Expanding the role of the FHLBanks in this fashion also leads to a number of other potential problems, including the fact that FHLB membership is not available as an option for all potential lenders (such as mortgage banks or brokers), and opening the system to these nondepositories would pose great and untenable risks to the existing owners-members of the system. Another problem is that the added risks associated with the new activities envisioned may be unappealing to a significant portion of the FHLB membership, which may resist expanding into these new lines of business, even if sufficient capital were available.

A more limited expansion of the role of the Federal Home Loan Banks may be more feasible. For example, you asked in your invitation letter about the feasibility of FHLBanks as aggregators of mortgages or security issuers. It is possible that the FHLBs' role as aggregators of loans originated by their members could be expanded, including the ability to hold such loans on their balance sheets for a period of time to facilitate the efficient aggregation and sale to investors (and to promote the cash sale of individual loans by members). It may be possible to authorize the FHLBs to issue securities as well, which is a position supported by some of the individual Banks in the System. Such a change must take care to ensure that securitization authority comes with sufficient oversight to ensure that it does not pose undue risk to an individual Federal Home Loan Bank or its counterparts, given the joint and several nature of FHLBank debt.

Another serious concern relates to the regulatory oversight of the FHLBanks. ABA is concerned with the approach taken in S.1217 which would transfer the supervisory and regulatory functions over the Federal Home Loan Banks from the Federal Housing Finance Agency to a newly created Federal Mortgage Insurance Corporation (FMIC). We are concerned that doing so creates a conflict of interest, whereby the FMIC is both a regulator of and to some degree a competitor to the Federal Home Loan Bank system. Both the FHLBs and FMIC would have a mission of supplying liquidity to the mortgage finance system. The FMIC, as currently envisioned, would likely grow to support a larger segment of the overall market than the FHLBs in their current form. Placing regulation of the FHLBs with the FMIC is likely to lead, at best, to neglect of the System and, at worst, to regulatory policies that may disadvantage the System and its owners/users.

Instead, we urge a different approach to the regulatory structure than that envisioned in S.1217. The FMIC should not serve as both a guarantor and a regulator, and with specific regard to FHLBanks, the traditional advance business should not be regulated by the new guarantor. Any expanded powers and activities granted to the FHLBanks which would permit them to engage in new activities (such as aggregation and securitization) under the new system, could potentially be regulated by the new regulator over the FMIC (as described above) on a functional basis, with the traditional advance activities of the Federal Home Loan Banks regulated by a separate agency devoted to only their regulation.

Finally, it is important to note that the Federal Home Loan Banks have functioned very successfully for 80 years in serving the liquidity needs of their member/owners and the communities and borrowers those lenders serve. No action taken by Congress should serve to destabilize or otherwise threaten that liquidity function.

A Transition to a New System Must Not Destabilize Mortgage Markets

ABA has long held that any transition to a new system must be undertaken carefully over a number of years to ensure that the mortgage markets are not destabilized.

Many details of a transition will be dictated by the ultimate new structure determined for the guarantor and the roles ultimately to be played by the private market in the new system. It is possible for a phased transition whereby some of the functions currently performed by Fannie and Freddie are slowly devolved to the private sector, such as aggregation and issuance of securities, with the role of Fannie and Freddie shrinking over time until they were only providing the guarantee function, which could ultimately be switched to the new guarantor. It will be essential that existing securities issued by Fannie and Freddie remain guaranteed going forward. Given the risk sharing exercises recently undertaken by Fannie Mae, it is possible that a transition could include a ramp up of such activities tailored to provide the framework for the first loss position desired under a new system.

Assets of the GSEs, including the automated underwriting systems and the single securitization platform, will have value to entities involved in a new system, and this relative value should be considered when determining how to best allocate them. If the Committee adopts the mutual open to all eligible primary market lenders as we have recommended above, we believe that there is merit in transferring these systems and the platform to this mutual. My bank, like many community banks, utilizes one of the GSEs' automated underwriting systems as it provides significant benefits, such as faster loan approvals, reduced closing costs, less documentation, and approval of loan applications that in the past were denied. We find Freddie Mac's automated system to be a valuable tool to aid in decision making. The automated underwriting systems cannot fully evaluate a file like a live underwriter can especially in the areas of character and collateral. We place a lot of importance on consistent evaluation and strong guidance on loan files to ensure equitable decision making.

Going forward, we also believe that the door should remain open to other underwriting systems beyond those owned by the GSEs for determining eligibility for the Federal guarantee going forward. Doing so encourages innovation. Any privately developed systems would have to be carefully evaluated and tested to ensure that they provide the same or better underwriting determinations as the existing systems. Additionally, transparency in any underwriting system should be encouraged, including in the existing systems or any evolution of them.

Conclusion

ABA believes that a Government guarantee on a limited segment of the market focused on low and moderate income mortgage borrowers is essential. This is best accomplished by developing a sustainable, rational, and limited role for the Federal Government in supporting and regulating mortgage markets so that there will always be credit available to qualified homebuyers not only during economic upswings but most importantly during downturns. Importantly, the Government guarantee must be explicit, fully priced into the cost of each mortgage to which it applies, and available to all eligible primary market lenders on an equitable basis regardless of size, charter type, geographic location, or number of loans sold into the secondary market. If community banks' access to that guarantee is curtailed or denied, or their pricing in the market is inequitable, they and the communities they serve will suffer.

We believe that S.1217 offers a good starting point for reform, but further work and detail is required. We hope that our comments, particularly with regard to the proposed mutual concept and the possible expansion of the activities of the Federal Home Loan Banks are helpful.

We have been pleased to work with the Committee and to provide feedback to your questions and stand ready to assist further. The current conservatorship status of Fannie Mae and Freddie Mac is unsustainable over the long term, as is a return to "business as usual" without significant reform of the Government's role in the secondary mortgage market. ABA and our members are committed to working with you to achieve a sustainable, durable, and equitable system.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM RICHARD SWANSON

Q.1. S.1217 proposes a fee on its member participants for the initial capitalization of the mutual securitization company. Specifically, how should such a fee be structured such that it's fair to all members, especially those members that bring more capital to the table? How do we balance the need for initial capitalization with the need for fairness?

A.1. There have been many instances in which Congress has provided for the initial capitalization of a mutual or cooperative type vehicle. Below are examples of some of the more prominent cooperative entities established by Federal law.

FHLBanks

The initial capitalization of the Federal Home Loan Banks was in the form of an injection of $125 million in Government funds. At the same time the Banks were directed to issue capital stock to members in an amount equal to 1 percent of any outstanding advance, with a minimum purchase requirement of $1,500. When the amount of paid in capital contributed by member institutions equaled the amount of the Treasury contribution, the Banks were required to repay the Treasury by allocating 50 percent of any additional capital contributions to retiring the Treasury's capital.

FHA Mutual Insurance Fund

The FHA's mutual insurance fund was created by the National Housing Act of 1934. The Fund was initially capitalized by the Federal Government in the amount of $10 million.

Rural Electric Cooperatives

Rural Electric Cooperatives are mutual organizations that provide electricity to rural areas of the country that could not be economically served by privately owned electric utilities. The formation of these State-chartered mutual organizations was encouraged by the Rural Electrification Administration (REA). Pursuant to the Rural Electrification Act of 1936 the REA was authorized to provide startup capital to these cooperatives through Federal loans with an amortization period of up to 25 years. In 1949 this program was expanded to include cooperatives providing rural telephone services.

Farm Credit System

The Farm Credit System is a nationwide network of borrower-owned lending institutions established by Congress in 1916 to provide a reliable source of credit for the Nation's farmers and ranchers. Under the 1916 legislation, the United States was divided into 12 Federal land bank districts, and a member-owned Federal Land Bank was established in each district. The Federal Land Banks were supervised by a new agency, the Federal Farm Loan Board. Initial capitalization was set at $750,000 for each bank. The Federal Farm Loan Board was directed to solicit subscriptions for these shares, but if the required amount for any bank was not raised within 30 days, the Federal Farm Loan Board was to purchase the shares necessary to reach the minimum capitalization level.

In 1933 Congress was required to recapitalize the Federal Land Banks through an appropriation of $189 million. Later that year Congress passed the Farm Credit Act that, among other things, expanded the program by establishing 12 Production Credit Associations and 12 Banks for Cooperatives. The initial capitalization of both were provided through appropriations.

Q.2. S.1217 provides that member participants of the mutual securitization company shall have equal voting rights regardless of the size of an individual member participant, and some have suggested a one member, one vote system. How do we prevent one member participant from effectively controlling more than one vote by acquiring controlling stakes in other member participants?

A.2. Under the Federal Home Loan Bank Act, the board of directors of each Federal Home Loan Bank is responsible for the management of that Bank. A majority of the board must be member directors, and at least 2/5ths of each board must be comprised of independent directors, including public interest directors. A member director is a director who is also an officer or director of a member institution located in the same district at the Bank. An independent director does not have such a position in a member institution. A public interest director is a director who has had at least 4 year's experience in a consumer or community group or similar organization.

All directors must be elected by a plurality vote of the member institutions. The member directorships are allocated to the States within the Bank's district, based on several factors including the percentage of required Bank stock held by institutions within each State. The institutions located in each State nominate a person for the directorship allocated to that State. Independent directors are elected by a plurality vote of the members of the Bank at large.

The Federal Home Loan Bank Act provides that no member may cast a number of votes in the election of directors greater than the average number of shares all the members in its specific State are required to hold. This prevents large members holding relatively large amounts of a FHLBank's capital stock from dominating director elections and, in practice, means that the majority of each FHLBank's member directors generally represent the smaller institutions that make up the great majority of all members.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM WILLIAM A. LOVING, JR.

Q.1. S.1217 proposes a fee on its member participants for the initial capitalization of the mutual securitization company. Specifically, how should such a fee be structured such that it's fair to all members, especially those members that bring more capital to the table? How do we balance the need for initial capitalization with the need for fairness?

A.1. ICBA has recommended an appropriation from the revenues of Fannie Mae and Freddie Mac to provide the initial capitalization of the mutual securitization company. ICBA also recommends that mutual could assess a modest fee to all approved lenders that sell loans to the mutual on an annual basis. This annual fee should not exceed $1,000.

Q.2. S.1217 provides that member participants of the mutual securitization company shall have equal voting rights regardless of the size of an individual member participant, and some have suggested a one member, one vote system. How do we prevent one member participant from effectively controlling more than one vote by acquiring controlling stakes in other member participants?

A.2. ICBA has recommended the board of the mutual be constructed similar to the boards of the FHLBs which have dealt with this issue.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM BILL HAMPEL

Q.1. In describing the ways in which first loss private capital could be structured, you state that while either a bond guarantor or some kind of senior-sub risk sharing transaction could accomplish this goal "in theory," you believe that "the bond guarantor approach would be preferable" in practice. Could you please elaborate?

A.1. In principle, either a bond guarantor or some form of senior-subordinate structure could serve to provide private capital to absorb first losses on covered securities. In this context, bond guarantors would be firms that conduct the routine business of guaranteeing covered securities, building sufficient reserves to cover potential losses on all securities guaranteed by that firm. Senior-sub structures on the other hand would produce tranches of securities that could be purchased by any investor who happened to have an appetite for that type of security when it was issued.

There are two drawbacks to the senior-sub structure as compared to bond guarantors. First, because of economies of scale in gathering information on individual loans and securities, senior-sub structures would be more economical for securities created by large issuers. Smaller originators would be at a disadvantage under senior-sub structures. Second, the risk-premium (price of the guarantee) of the subordinate portion of a senior-sub structure would vary dramatically through time, depending on investors' current evaluation of risk. That's because each transaction would involve a one-time exposure to risk for the investor, i.e., the risks of many securities would not be pooled as for a bond guarantor. In good times, when investors expect very low early defaults on mortgages, risk premiums would be very low. In very stressed markets, not even as severe as the conditions of 2007 to 2009, risk premiums would be so high as to price most senior-sub structures out of the market.

Because bond guarantors would build reserves over time, their pricing would be much more stable. However, the coexistence of senior-sub structures with bond guarantors would make it more difficult for bond guarantors to operate, as senior-sub structures would tend to underprice the market during good times. Therefore, the bond guarantor approach is more preferable in practice.

Q.2. S.1217 proposes a fee on its member participants for the initial capitalization of the mutual securitization company. Specifically, how should such a fee be structured such that it's fair to all members, especially those members that bring more capital to the table? How do we balance the need for initial capitalization with the need for fairness?

A.2. It would be more appropriate for the member/lenders of the mutual to be able to provide the initial capitalization of the mutual by means of an asset purchase (capital subscription) rather by a nonrefundable fee. Should an originator ever wish to discontinue use of the mutual, it would then be possible for that lender's capital contribution to be returned after an appropriate waiting period, and subject to the condition that the mutual was adequately capitalized. The amount of capital required of any lender should depend on that lender's sales of loans to the mutual, adjusted periodically for changes in volume. Initial volume could be determined by recent sales to the enterprises. In any event, the amount of capital required at the mutual should be modest since its balance sheet size would be very limited. Should the mutual generate net revenue beyond the amount necessary to maintain retained earnings, the excess should be returned to member/lenders either as a patronage refund or a dividend on contributed capital. A lender's voice in the governance of the mutual should in no way be weighted by that lender's capital contribution or lending volume.

The cost of operations of the mutual should be covered by transactions fees on originators or by the spread between what the mutual pays for loans and what it sells securities for. The operations fee or spread should not vary by transaction size.

Q.3. S.1217 provides that member participants of the mutual securitization company shall have equal voting rights regardless of the size of an individual member participant, and some have suggested a one member, one vote system. How do we prevent one member participant from effectively controlling more than one vote by acquiring controlling stakes in other member participants?

A.3. CUNA strongly supports the one-member, one-vote governance structure. This can be protected by providing that for purposes of voting, if a member has any affiliates that might otherwise be considered members, that member and its affiliates are as a group entitled to only one vote.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM BILL COSGROVE

Q.1. S.1217 proposes a fee on its member participants for the initial capitalization of the mutual securitization company. Specifically, how should such a fee be structured such that it's fair to all members, especially those members that bring more capital to the table? How do we balance the need for initial capitalization with the need for fairness?

A.1. Each Mutual Securitization Company should develop standards and procedures to approve the application of eligible institutions to become member participants of the Mutual Securitization Company. In no case should an application be given preference based on the asset size or potential volume of eligible mortgages the eligible institution may contribute to the Company. The fees for initial capitalization and ongoing access should be equitably assessed and any fees charged on a per loan basis should not vary based on the asset size or total volume of eligible mortgages that the member participant sells to such Mutual Securitization Company.

Q.2. S.1217 provides that member participants of the mutual securitization company shall have equal voting rights regardless of the size of an individual member participant, and some have suggested a one member, one vote system. How do we prevent one member participant from effectively controlling more than one vote by acquiring controlling stakes in other member participants?

A.2. Companies should have equal voting rights regardless of the size of the individual member participant or the volume of eligible mortgages contributed by the member participant. In order to prevent unnecessary concentration of risk, systemically important financial institutions should be prohibited from having controlling interests in mortgage insurers or bond guarantors.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM JOHN HARWELL

Q.1. S.1217 proposes a fee on its member participants for the initial capitalization of the mutual securitization company. Specifically, how should such a fee be structured such that it's fair to all members, especially those members that bring more capital to the table? How do we balance the need for initial capitalization with the need for fairness?

A.1. Credit unions did not cause the financial crisis, and I believe historical mortgage lending data should be taken into account as the secondary mortgage market is reformed. The fee structures associated with the mutual should be based on loan quality as opposed to the volume of loans an entity is able to generate. I also believe asset size should play a factor in capitalization, with larger entities that opt into the mutual being responsible for a proportional amount of the capitalization fees. Fees, for example, could be based on the dollar amount or number of loans each institution moved through the mutual in the prior calendar year. This would keep fees in-line with the level of service the mutual provides to each member institution.

Q.2. S.1217 provides that member participants of the mutual securitization company shall have equal voting rights regardless of the size of an individual member participant, and some have suggested a one member, one vote system. How do we prevent one member participant from effectively controlling more than one vote by acquiring controlling stakes in other member participants?

A.2. As outlined in S.1217, I believe that member participants of the mutual securitization company should have equal voting rights regardless of the size of an individual member participant. Any housing finance reform language should be explicit in this regard, and ensure adequate credit union input throughout the process. Should such a mutual be adopted, the Committee should consider restricting the voting rights of parent or holding companies. As a parent company, you would get a single vote, regardless of how many subsidiaries you own that belong to the mutual. This could help address the concern raised by Senator Reed.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM JEFF PLAGGE

Q.1. S.1217 proposes a fee on its member participants for the initial capitalization of the mutual securitization company. Specifically, how should such a fee be structured such that it's fair to all members, especially those members that bring more capital to the table? How do we balance the need for initial capitalization with the need for fairness?

A.1. Capital charges to co-op members should be based on the risks they impose on the co-op entity. Variation in the riskiness of particular member activities likely will be governed in part by co-op rules that place limits on, discourage, or forbid certain types of risk behavior. To the extent that member actives that create risk for the co-op are not relatively homogeneous because of these rules, additional capital charges or other risk mitigation requirements associated with higher risk-taking activates should be required.

The primary differences in risks created for the co-op by member institutions is likely to be defined by the volume of operations. Capital requirements for each member should be based on activity levels, in a manner analogous to activity-based capital requirements required in the Federal Home Loan Bank System. In other words, capital requirements should be set by scope of usage of the co-op. Prudential capital standards and co-op governance cannot be maintained by a system of capital subscriptions that are equal for each member institution, as might be inferred by some readers of the question. In short, ABA believes the best approach is one similar to that taken by the Federal Home Loan Banks, which requires an initial purchase of stock (priced at par) for all members, and an activity based stock purchase requirement based upon scope of activities and the risks posed by those activities.

Q.2. S.1217 provides that member participants of the mutual securitization company shall have equal voting rights regardless of the size of an individual member participant, and some have suggested a one member, one vote system. How do we prevent one member participant from effectively controlling more than one vote by acquiring controlling stakes in other member participants?

A.2. It is essential that the largest users of the co-op have the biggest capital requirements. It is also essential that some mechanism prevent large users from voting their correspondingly higher capital positions. Otherwise, the co-op interests would become subsidiary to the interests of the biggest members, rather than equitably determined in the interest of all members. One member, one vote is a mechanism that might achieve the desired quality of governance. The Federal Home Loan Bank System has developed a more complex system to achieve the same objective of not subjugating the interest of the many to the power of the few. The FHFB approach is informative, though it developed in a unique institutional setting and in response to a long history not likely to be repeated. Therefore, the FHLB voting mechanisms might not be easily applied in a new institutional setting but can still serve as a guide for establishing a structure that balances members' interests and needs with their market activities and size.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

PREPARED STATEMENT SUBMITTED BY MARY MARTHA FORTNEY, PRESIDENT AND CEO, NASCUS

Chairman Johnson, Ranking Member Crapo, and distinguished Members of the Committee:

The National Association of State Credit Union Supervisors (NASCUS) appreciates the opportunity to provide this written statement for the record of the November 5, 2013, Senate Committee on Banking, Housing, and Urban Affairs hearing regarding the importance of protecting credit union access to the secondary mortgage market. As the professional association of the Nation's State credit union regulatory agencies, NASCUS has been committed to enhancing State credit union supervision and advocating for a safe and sound State credit union system since its inception in 1965.

NASCUS applauds the Committee's efforts in addressing this difficult issue and providing much needed reform to the housing finance market. While the Housing Finance Reform and Taxpayer Protection Act of 2013 (S.1217) provides for wide-ranging reform, NASCUS' comments will focus on the prudential benefits of maintaining credit union access to the secondary mortgage market, and the importance of streamlined coordination and information sharing between any new Federal regulatory agency and the primary prudential regulator for the issuing or servicing financial institution.

Credit unions serve more than 97 million members across the country and play a vital role in the first mortgage market, especially in markets where larger financial institutions do not operate. Without a legislative mandate to maintain small lender access to the system, small lenders will effectively be shut out of the secondary market, which will undermine their ability to provide loans and services in already underserved areas. Any reform to the housing finance system should preserve the ability of small institutions to sell single loans directly into the secondary market, maintain existing standardization and digital underwriting programs, and embrace a pricing structure that values loan quality over lending volume. Small and medium sized credit unions generally do not produce the type of loan volume that would be required to participate in a secondary market system without these provisions built in.

Credit unions did not cause the financial crisis, and their cooperative structure and conservative community based lending model allowed them to serve as a source of stability during the financial crisis when other lenders were unable or reluctant to provide needed credit in the housing marketplace. The reformed system should recognize the countercyclical benefits of maintaining an active presence of cooperative financial institutions in the mortgage market and the bill should protect that presence through appropriate pricing and access mechanisms.

From a safety and soundness perspective, the ability to sell mortgages into the secondary market helps credit unions to manage interest rate risk and provides them with a source of liquidity. While most depository institutions are vulnerable to interest rate risk because they use short-term liabilities to fund long-term fixed-rate assets, credit unions face an additional challenge in that their ability to generate capital from other sources when interest spreads tighten is limited by statute.[1]

As not-for-profit cooperative institutions, credit unions cannot turn to investors to generate needed capital, and must rely on their retained earnings. Consequently, credit unions must be particularly vigilant regarding rising interest rates, which can deplete retained earnings as the cost of funds rise compared to the credit union's return on assets. Although credit unions have an assortment of tools with which to manage interest rate risk, the ability to sell fixed-rate mortgages into the secondary market remains a critical element of effective risk management for many credit unions. In addition, the ability to sell individual mortgages directly into the secondary market for cash provides credit unions with a valuable source of liquidity, which enables them to offer additional loans and better products to their members. State regulators want to ensure that the pursuit of a safe and sound secondary market does not inadvertently undermine the ability of entities that offer consumer

[1] Under current law, most credit unions are limited to retained earnings to build their net worth ratio for Prompt Corrective Action (PCA) purposes. The Capital Access for Small Businesses and Jobs Act (H.R. 719) would amend the Federal Credit Union Act to allow sufficiently capitalized and well-managed credit unions to receive payments on certain uninsured nonshare accounts, and count them toward PCA requirements. NASCUS supports this important and necessary legislation.

friendly fixed-rate mortgages, such as credit unions, to provide vital financial products to their members in a safe and sound manner.

NASCUS urges the Committee to facilitate an orderly secondary market system that works in coordination with primary State and Federal regulators in order to ensure seamless oversight while minimizing regulatory burden. The Committee should consider amending S.1217 to require the Federal Mortgage Insurance Corporation (FMIC) to coordinate with primary prudential regulators, whether State or Federal, when promulgating rules that would affect the institutions under their jurisdiction.

Currently, section 212(a)(3) only requires FMIC to coordinate with the Consumer Financial Protection Bureau (CFPB) and, to the extent practical and appropriate, the other Federal banking agencies when developing standards for approval of servicers to administer eligible mortgages. As of March 2013, almost 40 percent of all credit unions in the country were State-chartered, and the ability to retain servicing rights on their members' loans is important for many of them. As a result, many State-chartered credit unions may be tweaking their operations in order to qualify as a mortgage servicer with FMIC. A statutory mandate that includes coordination with State regulators would facilitate information sharing and discussion that could prevent duplicative or conflicting regulation, reduce unnecessary cost and delay, and facilitate safe, sound, and efficient oversight of the mortgage market as a whole.[2]

NASCUS appreciates the opportunity to submit written comments to the Senate Committee on Banking, Housing, and Urban Affairs on this important issue. As drafted, S.1217 reflects a real understanding of the value that small lenders bring to the system, and NASCUS appreciates the efforts of the Committee in fine-tuning the proposal to ensure access for all lenders. NASCUS and its State regulator members are available to answer any questions that the Committee may have regarding the safety and soundness implications of the proposed reform, and we look forward to continued dialogue on the issue as the bill progresses.

[2] NASCUS would be happy to suggest appropriate statutory language or meet with Committee staff to elaborate on this suggestion.